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MONETARY POLICY AND THE STATE OF THE ECONOMY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

FEBRUARY 24, 2010

Printed for the use of the Committee on Financial Services

Serial No. 111–102

U.S. GOVERNMENT PRINTING OFFICE

56–766 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, February 24, 2010

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

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Gutierrez, Velazquez, Watt, Sherman, Meeks, Moore of Kansas, Hinojosa, Clay, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Klein, Wilson, Perlmutter, Donnelly, Foster, Carson, Minnick, Adler, Kosmas, Grayson, Himes, Peters; Bachus, Castle, Royce, Paul, Manzullo, Biggert, Miller of California, Capito, Hensarling, Garrett, Neugebauer, McHenry, Campbell, Putnam, Bachmann, Marchant, McCotter, McCarthy of California, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. This is the semi-annual hearing held pursuant to the Humphrey-Hawkins Act. I should note that Mr. Hawkins is represented here in the fact that his successor in Congress is our colleague from Los Angeles, Ms. Waters. We are in the direct Humphrey-Hawkins' succession here.

This is the semi-annual hearing. As people know, the Chairman of the Federal Reserve testifies before both the House and the Senate. He goes first here. Tomorrow, he goes to the Senate.

This is one of those occasions when we can act first and have confidence that the Senate will in fact act second. We cannot always make that assumption, unfortunately, but we can in this case, because all they have to do is sit there and listen.

We will begin. Under the rules of the committee, each side will have 8 minutes. We want to move quickly. We have divided up the time according to each side's decision. We will begin, and I will yield 2½ minutes to my colleague from Illinois, Mr. Foster, to begin the statements.

Mr. FOSTER. Thank you, Mr. Chairman. As a scientist, I have always found that numbers are more illuminating than ideology and talking points, so on the chart that I believe will be displayed on the monitors in a moment, I have plotted some interesting numbers that I downloaded from the Flow of Funds Report that the Federal Reserve Web site updates each quarter.

It shows that from July 2007 to March 2009, roughly the last year-and-a-half of the previous Administration, the net worth of households in the United States dropped by $17.5 trillion.

Our economy is suffering from the aftermath of the largest destruction of wealth in human history.

Under Democratic leadership, since the passage of the stimulus and other important initiatives, this trend has been reversed. Our economy is now stabilized and household net worth has increased by more than $5 trillion.

The $17.5 trillion of wealth destroyed in the last months of the previous Administration is so large that it is hard to get your arms around. Just how large is $17.5 trillion: $17.5 trillion is more than 1.5 times the entire U.S. national debt; $17.5 trillion is more than 1 year of the U.S. GDP, which is roughly $14 trillion; $17.5 trillion is more than $57,000 for every man, woman, and child in the United States; and finally, $17.5 trillion is about 200 times larger than the anticipated losses in Fannie Mae and Freddie Mac.

Let's talk for a moment about the return on investment of the stimulus. When the dust settles, the total cost to taxpayers of the stimulus, TARP, and the other emergency interventions in our economy will be roughly $1 trillion.

In response, household wealth has rebounded by $5 trillion. I'm a businessman as well as a scientist and it seems to me that an investment of roughly $1 trillion that generates an increase in wealth of $5 trillion represents a pretty good return on investment.

If I could have the next slide, let's talk about job loss and unemployment. A year ago, over 700,000 jobs were being lost every month and the job losses were increasing by 100,000 more jobs lost each additional month. The economy was spiraling toward another great Depression.

After the passage of the stimulus and the other emergency measures to rescue our economy, job losses started decreasing promptly and job growth is said to turn positive by 2010.

Unfortunately, job recovery always takes longer than people would like. Most downturns take 1 to 2 years, if you look at them in the stock market, and 2 to 3 years if you look at unemployment. That is just the way it is.

It is very difficult for a reasonable person to look at this data and conclude that Democratic policies have not been effective at dealing with job loss.

Finally, how did we get here?

The CHAIRMAN. The gentleman's time has expired.

Mr. WATT. Mr. Chairman, might I yield him some of my time?

The CHAIRMAN. Yes, does the gentleman want to yield 30 seconds?

Mr. WATT. Yes, so he can finish. It is such a powerful statement he is making.

The CHAIRMAN. I thank the gentleman from North Carolina.

Mr. FOSTER. Finally, I would just like to make one last comment on how did we get here. It is important to understand that the $17.5 trillion of destruction of household wealth that our country just experienced was not the result of a normal business cycle. It was the result of an ideologically driven deregulation of the financial markets.

Most importantly, it will happen again if we do not understand and acknowledge what happened and take steps to prevent it from recurring.

Thank you. I yield back.

The CHAIRMAN. I thank the gentleman from North Carolina. The gentleman from North Carolina will have 2 minutes and 10 seconds.

The gentleman from Texas is now recognized, the ranking member of the Subcommittee on Domestic and International Monetary Policy, for 3 minutes.

Dr. PAUL. Thank you, Mr. Chairman. Welcome, Chairman Bernanke.

I am interested in the suggestion that Mr. Volcker has made recently about curtailing some of the investment banking risk they are taking. In many ways, I think he brings up a very important subject and touches on it, but I think it is much bigger than what he has addressed.

Back when we repealed Glass-Steagall, I voted against this, even though as a free market person, I endorse the concept that banks ought to be allowed to do commercial and investment banking.

The real culprit, of course, is the insurance, the guarantee behind this, and the system of money that we have.

In a free market, of course, the insurance would not be guaranteed by the taxpayers or by the Federal Reserve creating more money. The FDIC is an encouragement of moral hazard as well.

I think the Congress contributes to this by pushing loans on individuals who do not qualify, and I think the Congress has some responsibility there, too.

I also think there has been a moral hazard caused by the tradition of a line of credit to Fannie Mae and Freddie Mac and this expectation of artificially low interest rates helped form the housing bubble, but also the concept still persists, even though it has been talked about, that it is too-big-to-fail. It exists and nobody is going to walk away.

There is always this guarantee that the government will be there along with the Federal Reserve, the Treasury, and the taxpayers to bail out anybody that looks like it is going to shake it up.

It does not matter that the bad debt and the burden is dumped on the American taxpayer and on the value of the dollar, but it is still there. "Too-big-to-fail" creates a tremendous moral hazard.

Of course, the real moral hazard over the many decades has been the deception put into the markets by the Federal Reserve creating artificially low interest rates, pretending there has been savings, pretending there is actually capital out there, and this is what causes the financial bubbles, and this is the moral hazard because people believe something that is not true, and it leads to the problems we have today because it is unsustainable.

It works for a while, but eventually, we have to pay the price. The moral hazard catches up with us and then we see the disintegration of the system that we have artificially created.

We are in a situation coming up soon, even though we have been already in a financial crisis, we are going to see this get much worse and we are going to have to address this subject of the monetary system and whether we want to have a system that does not guarantee that we will always bail out all the banks and dump these bad debts on the people, and that it is filled with moral hazard, the whole system is.

When that time comes, I hope we come to our senses and decide that the free market works pretty well. It gets rid of these problems much sooner and much smoother than when it becomes politicized that some firms get bailed out and others get punished. It is an endless battle.

Hopefully, we will see the light and do a better job in the future.

The CHAIRMAN. The gentleman from North Carolina is now recognized for 2 minutes and 10 seconds.

Mr. WATT. Thank you, Mr. Chairman.

Over the last two breaks in August of last year and the President's break this year, Mr. Meeks, as chairman of the International Monetary Policy Subcommittee, and myself as chairman of the Domestic Monetary Policy Subcommittee have traveled and met with Central Bank governors, finance ministers and leaders in Tunisia, Rwanda, Zimbabwe, Senegal, Nigeria, Ethiopia, Botswana, and The Gambia, to try to figure out what impact this economic downturn is having on African countries.

Today, we get a chance to hear the impact it is having on our own domestic economy and what we can do to try to address that impact.

Against that backdrop, the question I would really like to have addressed today is what tools the Fed has in its tool kit to reverse the trends and spur job growth in the 12th District of North Carolina and elsewhere in America.

I asked a similar question last year at the Humphrey-Hawkins' hearing, and at that time, Chairman Bernanke vowed to take strong and aggressive action to halt the economic slide and improve job growth.

One year later, unemployment has gotten worse, although there are small signs of recovery.

Today, I hope to hear specifics on the Fed's plan to spur job growth and meet the other half of this dual mandate, fostering maximum sustainable employment.

If there are things Congress can and should do to help, we should be ready to assist with that agenda.

With that, Mr. Chairman, I yield back and I will submit the rest of my statement for the record.

The CHAIRMAN. There are a couple of 1-minute statements. The gentleman from Florida, Mr. Posey, and if she is ready next, the gentlewoman from Kansas, Ms. Jenkins.

The gentleman from Florida is recognized for 1 minute for the Minority.

Mr. POSEY. Thank you, Mr. Chairman.

Chairman Bernanke, the Fed's decision to raise the discount rate can be interpreted that the Federal Reserve will raise the Federal fund's rate in the months ahead, which would suggest economic recovery is under way, yet the road ahead seems difficult.

The 2010 Economic Report of the President states "It will take a prolonged and robust GDP—I think they meant GOP—expansion to eliminate the jobs' deficit that has opened up over the course of the recession."

A question specifically is what are you looking for, and once again, what is the plan? I do not see how recovery can be defined without reducing unemployment and expanding GDP. It would also

be helpful to know how optimistic the Fed is for GDP expansion in light of some of the job-killing policies coming out of Washington.

For example, I recently learned the President's budget would kill our human space exploration program and send our high-skilled jobs to Russia.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Kansas for 1 minute.

Ms. JENKINS. Thank you, Mr. Chairman.

Over the past 18 months, the Fed has taken extraordinary steps to address the financial downturn. Last year, Chairman Bernanke spoke about the importance of reducing our deficit spending and making a real commitment to fiscal discipline.

Today, the deficit exceeds 10 percent of GDP and as evidenced by the Administration's budget proposal, they are not making such a commitment.

Since joining this committee, my priority has been to protect the taxpayers by ending bailouts and preventing future taxpayer-funded bailouts.

I have concerns about TARP, and I am interested to hear how the Chairman intends to pull back on the increased liquidity without further disrupting our markets.

I am also interested to learn if he believes a true economic recovery can occur with continued excessive deficits.

I yield back the remainder of my time.

The CHAIRMAN. The gentleman from New York will now be recognized for 1 minute, and then we will get to the gentlemen from Minnesota and New Jersey.

Mr. LEE. Thank you, Mr. Chairman.

Chairman Bernanke, thank you for coming before the committee today. I know there will be a number of important issues that you will be raising over the course of your testimony, but I wanted to highlight just a few specific ones that I hope you can address during your discussion.

It is important for us to hear your thoughts on the significant level of spending that is currently going on in this Congress.

As you know, we just raised the debt ceiling by another $1.9 trillion, and whether you believe Fannie Mae/Freddie Mac, that exposure, should be factored into the debt ceiling that we currently live by.

I am also increasingly concerned with discussions by rating firms in which the AAA rating that this country currently enjoys is in jeopardy and when and if do you think that will be downgraded.

We simply cannot ignore what we are doing in terms of spending in this country and the impact it may have on us.

I look forward to you replying to those through your testimony.

The CHAIRMAN. I now recognize myself. I am told I have 2 minutes and 50 seconds.

I want to begin by responding to that last point. The notion that America will never not pay its debts is without any foundation. I frankly regard it as very irresponsible for anyone here to suggest there could ever be any such failure.

Inviting the rating agencies without any fact or basis whatever to raise our interest rates would be a mistake. The rating agencies

have done enough damage. I do not doubt for one second that this Congress will fully fund any obligations we have internationally.

Secondly, I did want to respond on bailouts. I understand the nostalgia some of my Republican friends have for the past Administration, which is when the bailouts happened.

Every single activity of the Federal Government that is now going forward that is called a "bailout" was begun by the Bush Administration, in most cases, for very good reasons, but by the Bush Administration and its high economic officials, in some cases in conjunction with Congress, in other cases, on their own, without any congressional input, like Bear Stearns and the first part of AIG.

I am not aware of any bailouts that were initiated since President Obama took over in this Administration.

Next, I want to talk about jobs. One of my Republican colleagues likes to ask, where are the jobs? I guess they all do. They tend to talk from the same notes.

I do not know where they are. Maybe they are in Crawford. Here is the figure that we have on pages 18 and 19 of the Monetary Report. Non-farm private payroll employment fell 725,000 jobs per month on average from January to April 2009. I know it is the Republican view that everything bad in America started on January 21, 2009 and before that, everything was wonderful.

No rational individual claims that the Obama Administration is responsible for things that happened in January, February, and April of this year.

By November to January, 2009 and 2010, for which the Obama Administration can get some responsibility, and after the Economic Recovery bill was passed, we averaged a loss of 20,000 jobs per month. That means we got a positive swing of 700,000 jobs. Unfortunately, it is not the most important swing, which is to a plus.

What that means is by these figures in the Federal Reserve, for the first 3 months of 2009, we lost 2.1-something million jobs, and in the last 3 months—November, December, January—we lost 60,000 jobs.

The answer is 2.1 million jobs disappeared and have not yet come back because of the economy that the Obama Administration inherited.

I do note that the Chairman twice notes the positive impact of the stimulus on the economy. There are a number of things, but both in his statements and in the Monetary Report, as he lists the reasons why the economy has gotten better, the stimulus is twice mentioned.

It is possible to debate what was the best way to do the stimulus. Some people like to exaggerate the extent to which it was spending, including some tax deduction—I think not too effective tax deduction, but no sensible human being can deny the stimulus had a positive effect. The question is, going forward, can we improve on that positive effect.

Now I recognize the gentleman from Minnesota for 1 minute.

Mr. PAULSEN. Thank you, Mr. Chairman, for being here this morning as well. I have two issues of particular concern and hopefully, you will be able to address them.

The first is the lack of available credit for the small business community and the fear that if the Fed raises interest rates in the near term, it will further erode credit opportunities for small business and exacerbate that problem.

I would like to hear about the potential of the Fed Reserve increasing rates in the near future and ensuring that credit for small businesses is going to be available for job growth.

Second, the issue of the explosion of the deficit and the debt, and the warning signals are getting louder that our fiscal situation is putting increasing pressure on our bond rating.

I would like your opinion on the long-term impact of not addressing our debt as it relates to our bond rating, but more importantly, the impact it would have on our global competitiveness.

Thank you and I do look forward to your testimony.

The CHAIRMAN. The gentleman from New Jersey for the final minute.

Mr. LANCE. Thank you for coming back to our committee, Chairman Bernanke.

Last week, like most of our colleagues, I was back home as part of the President's Day District work period. As I traveled throughout New Jersey's 7th Congressional District in northern and central New Jersey, I was speaking with constituents and meeting with small businesses, and I heard a common refrain, people are deeply concerned about the state of the United States' economy.

Most New Jerseyans believe we are still mired in a deep recession and they are extremely concerned about job prospects and income worries.

These concerns, which I believe exist across the Nation, will likely lead to curbed consumer spending for some time to come.

I hope, sir, in your testimony to the committee this morning, you will address this issue and what the Fed intends to do moving forward to boost consumer confidence, which after all, constitutes 70 percent of our economic activity.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. That concludes the opening statements. I thank all the members for adhering to the time limits.

Mr. Chairman, we will not hold you to the 5 minutes. I think the economy probably deserves a 3 or 4 extra minutes this morning, so you take whatever time you think is necessary to tell us how you are going to fix everything.

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

Mr. BERNANKE. Thank you, Mr. Chairman. I will try not to abuse that.

Chairman Frank, Ranking Member Bachus, and other members of the committee, I am pleased to present the Federal Reserve's semi-annual Monetary Policy Report to the Congress.

I will begin today with some comments on the outlook for the economy and for monetary policy, then touch briefly on several other important issues.

Although the recession officially began more than 2 years ago, U.S. economic activity contracted particularly sharply following the

intensification of the global financial crisis in the fall of 2008. Concerted efforts by the Federal Reserve, the Treasury Department, and other U.S. authorities to stabilize the financial system, together with highly stimulative monetary and fiscal policies, helped arrest the decline and are supporting a nascent economic recovery. Indeed, the U.S. economy expanded at about a 4 percent annual rate during the second half of last year. A significant portion of that growth, however, can be attributed to the progress that firms have made in working down unwanted inventories of unsold goods, which have left them more willing to increase production. As the impetus provided by the inventory cycle is temporary, and as the fiscal support for economic growth will likely diminish later this year, a sustained recovery will depend on continued growth in private-sector final demand for goods and services.

Private-sector final demand does seem to be growing at a moderate pace, buoyed in part by a general improvement in financial conditions. In particular, consumer spending has recently picked up, reflecting gains in real disposable income and household wealth and tentative signs of stabilization in the labor market. Business investment in equipment and software has risen significantly. And international trade—supported by a recovery in the economies of many of our trading partners—is rebounding from its deep contraction of a year ago. However, starts of single-family homes, which rose notably this past spring, have recently been roughly flat, and commercial construction is declining sharply, reflecting poor fundamentals and continued difficulty in obtaining financing.

The job market has been hit especially hard by the recession, as employers reacted to sharp sales declines and concerns about credit availability by deeply cutting their workforces in late 2008 and in 2009. Some recent indicators suggest that the deterioration in the labor market is abating: Job losses have slowed considerably, and the number of full-time jobs in manufacturing rose modestly in January. Initial claims for unemployment insurance have continued to trend lower, and the temporary services industry, often considered a bellwether for the employment outlook, has been expanding steadily since October. Notwithstanding these positive signs, the job market remains quite weak, with the unemployment rate near 10 percent and job openings scarce. Of particular concern because of its long-term implications for worker's skills and wages, is the increasing incidence of long-term unemployment; indeed, more than 40 percent of the unemployed have been out of work for 6 months or more, nearly double the share of a year ago.

Increases in energy prices resulted in a pick-up in consumer price inflation in the second half of last year, but oil prices have flattened out over recent months, and most indicators suggest that inflation likely will be subdued for some time. Slack in labor and product markets has reduced wage and price pressures in most markets, and sharp increases in productivity have further reduced producers' unit labor costs. The cost of shelter, which receives a heavy weight in consumer price indexes, is rising very slowly, reflecting high vacancy rates. In addition, according to most measures, longer-term inflation expectations have remained relatively stable.

The improvement in financial markets that began last spring continues. Conditions in short-term funding markets have returned to near pre-crisis levels. Many (mostly larger) firms have been able to issue corporate bonds or new equity and do not seem to be hampered by a lack of credit. In contrast, bank lending continues to contract, reflecting both tightened lending standards and weak demand for credit amid uncertain economic prospects.

In conjunction with the January meeting of the Federal Open Market Committee, Board members and Reserve Bank presidents prepared projections for economic growth, unemployment, and inflation for the years 2010 through 2012 and over the longer run. The contours of these forecasts are broadly similar to those I reported to the Congress last July. FOMC participants continue to anticipate a moderate pace of economic recovery, with economic growth of roughly 3 to 3½ percent in 2010 and 3½ to 4½ percent in 2011. Consistent with moderate economic growth, participants expect the unemployment rate to decline only slowly, to a range of roughly 6½ to 7½ percent by the end of 2012, still well above their estimate of the long-run sustainable rate of about 5 percent. Inflation is expected to remain subdued, with consumer prices rising at rates between 1 and 2 percent in 2010 through 2012. In the longer term, inflation is expected to be between 1¾ and 2 percent, the range that most FOMC participants judge to be consistent with the Federal Reserve's dual mandate of price stability and maximum employment.

Over the past year, the Federal Reserve has employed a wide array of tools to promote economic recovery and preserve price stability. The target for the Federal funds rate has been maintained at a historically low range of 0 to ¼ percent since December 2008. The FOMC continues to anticipate that economic conditions—including low rates of resource utilization, subdued inflation trends, and stable inflation expectations—are likely to warrant exceptionally low levels of the Federal funds rate for an extended period.

To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. We have been gradually slowing the pace of these purchases in order to promote a smooth transition in markets and anticipate that these transactions will be completed by the end of March. The FOMC will continue to evaluate its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

In response to the substantial improvements in the functioning of most financial markets, the Federal Reserve is winding down the special liquidity facilities created during the crisis. On February 1st, a number of these facilities, including credit facilities for primary dealers, lending programs intended to help stabilize money market mutual funds and the commercial paper market, and temporary liquidity swap lines with foreign central banks, were all allowed to expire. The only remaining lending program for multiple borrowers created under the Federal Reserve's emergency authorities, the Term Asset-Backed Securities Loan Facility or TALF, is scheduled to close on March 31st for loans backed by all types of

collateral except newly issued commercial mortgage-backed securities (CMBS) and on June 30th, for loans backed by newly issued CMBS.

In addition to closing its special facilities, the Federal Reserve is normalizing its lending to commercial banks through the discount window. The final auction of discount-window funds to depositories for the Term Auction Facility, which was created in the early stages of the crisis to improve the liquidity of the banking system, will occur on March 8th. Last week, we announced that the maximum term of discount window loans, which was increased to as much as 90 days during the crisis, would be returned to overnight for most banks, as it was before the crisis erupted in August 2007. To discourage banks from relying on the discount window rather than private funding markets for short-term credit, last week we also increased the discount rate by 25 basis points, raising the spread between the discount rate and the top of the target range for the Federal funds rate to 50 basis points. These changes, like the closure of most of the special lending facilities earlier this month, are in response to the improved functioning of financial markets, which has reduced the need for extraordinary assistance from the Federal Reserve. These adjustments are not expected to lead to tighter financial conditions for households and businesses and should not be interpreted as signaling any change in the outlook for monetary policy, which remains about the same as it was at the time of the January meeting of the FOMC.

Although the Federal funds rate is likely to remain exceptionally low for an extended period, as the expansion matures, the Federal Reserve will at some point need to begin to tighten monetary conditions to prevent the development of inflationary pressures. Notwithstanding the substantial increase in the size of its balance sheet associated with its purchases of Treasury and agency securities, we are confident that we have the tools we need to firm the stance of monetary policy at the appropriate time.

Most importantly, in October 2008, the Congress gave statutory authority to the Federal Reserve to pay interest on banks' holdings of reserve balances at Federal Reserve banks. By increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates. Actual and prospective increases in short-term interest rates will be reflected in longer-term interest rates and in financial conditions more generally.

The Federal Reserve has also been developing a number of additional tools to reduce the large quantity of reserves held by the banking system, which will improve the Federal Reserve's control of financial conditions by leading to a tighter relationship between the interest rate paid on reserves and other short-term interest rates. Notably, our operational capacity for conducting reverse repurchase agreements, a tool that the Federal Reserve has historically used to absorb reserves from the banking system, is being expanded so that such transactions can be used to absorb large quantities of reserves. The Federal Reserve is also currently refining plans for a term deposit facility that could convert a portion of depository institutions' holdings reserve balances into deposits that are less liquid and cannot be used to meet reserve requirements.

In addition, the FOMC has the option of redeeming or selling securities as a means of reducing outstanding bank reserves and applying monetary restraint. Of course, the sequencing of steps and the combination of tools that the Federal Reserve uses as it exits from its currently very accommodative policy stance will depend on economic and financial developments. I have provided more discussion of these options and possible sequencing in a recent testimony.

The Federal Reserve is committed to ensuring that the Congress and the public have all the information needed to understand our decisions and to be assured of the integrity of our operations. Indeed, on matters related to the conduct of monetary policy, the Federal Reserve is already one of the most transparent central banks in the world, providing detailed records and explanations of its decisions. Over the past year, the Federal Reserve also took a number of steps to enhance the transparency of its special credit and liquidity facilities, including the provision of regular extensive reports to the Congress and the public; we have worked closely with the Government Accountability Office (GAO), the Office of the Special Inspector General for the Troubled Asset Relief Program (SIG TARP), the Congress, and private-sector auditors on a range of matters relating to these facilities.

While the emergency credit and liquidity facilities were important tools for implementing monetary policy during the crisis, we understand that the unusual nature of those facilities creates a special obligation to assure the Congress and the public of the integrity of their operation. Accordingly, we would welcome a review by the GAO of the Federal Reserve's management of all facilities created under emergency authorities. In particular, we would support legislation authorizing the GAO to audit the operational integrity, collateral policies, use of third-party contractors, accounting, financial reporting, and internal controls of these special credit and liquidity facilities. The Federal Reserve will, of course, cooperate fully and actively in all reviews. We are also prepared to support legislation that would require the release of the identities of the firms that participated in each special facility after an appropriate delay. It is important that the release occur after a lag that is sufficiently long that investors will not view an institution's use of one of the facilities as a possible indication of ongoing financial problems, thereby undermining market confidence in the institution or discourage use of any future facility that might become necessary to protect the U.S. economy.

Looking ahead, we will continue to work with the Congress in identifying approaches for enhancing the Federal Reserve's transparency that are consistent with our statutory objectives of fostering maximum employment and price stability. In particular, it is vital that the conduct of monetary policy continue to be insulated from short-term political pressures so that the FOMC can make policy decisions in the longer-term economic interests of the American people. Moreover, the confidentiality of discount window lending to individual depository institutions must be maintained so that the Federal Reserve continues to have effective ways to provide liquidity to depository institutions under circumstances where other sources of funding are not available. The Federal Reserve's ability to inject liquidity into the financial system is critical for pre-

serving financial stability and for supporting depositories' key role in meeting the ongoing credit needs of firms and households.

Strengthening our financial regulatory system is essential for the long-term economic stability of the Nation. Among the lessons of the crisis are the crucial importance of macroprudential regulation—that is, regulation and supervision aimed at addressing risks to the financial system as a whole—and the need for effective consolidated supervision of every financial institution that is so large or interconnected that its failure could threaten the functioning of the entire financial system.

The Federal Reserve strongly supports the Congress' ongoing efforts to achieve comprehensive financial reform. In the meantime, to strengthen the Federal Reserve's oversight of banking organizations, we have been conducting an intensive self-examination of our regulatory and supervisory responsibilities and have been actively implementing improvements. For example, the Federal Reserve has been playing a key role in international efforts to toughen capital and liquidity requirements for financial institutions, particularly systemically critical firms, and we have been taking the lead in ensuring that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking.

The Federal Reserve is also making fundamental changes in its supervision of large, complex bank holding companies, both to improve the effectiveness of consolidated supervision and to incorporate a macroprudential prospective that goes beyond the traditional focus on safety and soundness of individual institutions. We are overhauling our supervisory framework and procedures to improve coordination within our own supervisory staff and with other supervisory agencies and to facilitate more-integrative assessments of risks within each holding company and across groups of companies.

Last spring, the Federal Reserve led the successful Supervisory Capital Assessment Program, popularly known as the "bank stress test." An important lesson of that program was that combining onsite bank examinations with a suite of quantitative and analytical tools can greatly improve comparability of the results and better identify potential risks. In that spirit, the Federal Reserve is also in the process of developing an enhanced quantitative surveillance program for large bank holding companies. Supervisory information will be combined with firm-level, market-based indicators and aggregate economic data to provide a more complete picture of the risks facing these institutions and the broader financial system. Making use of the Federal Reserve's unparalleled breath of expertise, this program will apply a multidisciplinary approach that involves economists, specialists in particular financial markets, payment systems experts, and other professionals, as well as bank supervisors.

The recent crisis has also underscored the extent to which direct involvement in the oversight of banks and bank holding companies contributes to the Federal Reserve's effectiveness in carrying out its responsibilities as a central bank, including the making of monetary policy and the management of the discount window. Most important, as the crisis has once again demonstrated, the Federal Re-

serve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.

The Federal Reserve continues to demonstrate its commitment to strengthening consumer protections in the financial services arena. Since the time of the previous Monetary Policy Report in July, the Federal Reserve has proposed a comprehensive overhaul of the regulations governing consumer mortgage transactions, and we are collaborating with the Department of Housing and Urban Development to assess how we might further increase transparency in the mortgage process. We have issued rules implementing enhanced consumer protections for credit card accounts and private student loans as well as new rules to ensure that consumers have meaningful opportunities to avoid overdraft fees. In addition, the Federal Reserve has implemented an expanded consumer compliance supervision program for nonbank subsidiaries of bank holding companies and foreign banking organizations.

More generally, the Federal Reserve is committed to doing all that can be done to ensure that our economy is never again devastated by a financial collapse. We look forward to working with the Congress to develop effective and comprehensive reform of the financial regulatory framework.

Thank you, Mr. Chairman.

[The prepared statement of Chairman Bernanke can be found on page 71 of the appendix.]

The CHAIRMAN. Mr. Chairman, one of my colleagues, it may have been Mr. Paulsen or Mr. Lee, raised a question of lending to small business. I was pleased to note on page 13 of the Monetary Report, you cite the Federal financial regulatory agency, Conference of State Bank Supervisors' statement telling the regulators in the field not to overdo it. That does not mean you think they are, but it does mean you recognize there is a problem. We call it the "mixed message problem" that we have.

I am not going to take too much time now, but I would note we have a hearing on Friday on that subject, which had been previously scheduled and snowed out. It is an all-day hearing on regulation. Governor Duke will be testifying. We appreciate your doing it. It is very important.

We are getting everybody in the same room, the banks who say the regulators are being too tough on us, the regulators who say the problem is there is not any demand, and the borrowers who say the banks will not lend to us.

We thought it was important to get everybody in the same room. It is an all-day hearing in corroboration with our colleagues on the Small Business Committee chaired by my colleague, Ms. Velazquez.

I appreciate your mentioning that. We will be getting into that.

I want to talk now about the central question of employment. Getting people back to work is important, socially most of all, but also for the overall economy.

I was pleased to see you note on a couple of occasions, if you have a debate, you debate history, but it is part of a debate over policy as to whether or not an economic stimulus should take place.

We do have a deficit. When we do stimulative things, it does in the short term add to the deficit, I would note, both by expenditures and by tax cuts.

People have taken to talking about the total stimulus numbers as if it was all expenditures. About 30 percent of it was tax-cutting. People may or may not think that worked well.

I was struck to note that in your statement, you say "Concerted efforts to stabilize the financial system together with highly stimulative monetary and fiscal policy," and in the report in the very first paragraph, "The U.S. economy turned up in the second half supported by an improvement in financial conditions, stimulus from monetary and fiscal policies," and then again on page 8, "A development that helped rebuild household wealth and household income was lifted by provisions in the fiscal stimulus package."

These are three references to the extent to which the stimulus package which this Congress adopted aided in reducing unemployment and in stimulating the economy.

That has become controversial because you have to do it again. Am I accurate in interpreting your comments as saying the stimulus, without saying it was the best possible way to do it, but the fact that the stimulus was adopted did contribute to the improvement we are seeing in economic activity?

Mr. BERNANKE. Yes, Mr. Chairman. I think most economists would agree that the stimulus has created jobs relative to where the baseline would have been in the absence of the stimulus. Of course, we do not know what that alternative would have been, and therefore, it is very difficult to—

The CHAIRMAN. We do know one alternative, which was to do nothing, because if people say the major thing was the deficit, there was nothing you could have done that would have been a short-term stimulative that would not have added to the deficit, whether it was tax reduction or something else.

I know there are people who argue that if you do tax reduction, it means more revenue. I do remember your predecessor, Mr. Greenspan, asked by one of my Republican colleagues if it was not true that if you cut taxes, you could raise revenue overall, and he said that was theoretically possible but it had not happened in his lifetime. I do not think it has happened since then either.

This is important. I say that for this reason: We should have a thoughtful debate about what to do next. When we are bogged down in a debate about whether we should have done anything, it is not very helpful. I appreciate your comments on that.

Let me ask, at this point going forward, and I understand your primary responsibility is monetary policy, should we say that concerns for not increasing the deficit is so important that nothing further should be done that would have a fiscally stimulative effect?

Mr. BERNANKE. Mr. Chairman, you know, that is really the congressional tradeoff that has to be made. Obviously, unemployment is the biggest problem we have, and if the Federal Reserve and the Congress can address that issue, we need to find ways to address that issue, but there are difficult tradeoffs.

The CHAIRMAN. I appreciate that. I think we are aided by the fact that inflation is not now or in the near term seeming to be a problem.

The last point I would make if you could comment, we hear this threat that the rating agencies might reduce our debt rating because of the deficit. Do you think there is any realistic prospect of America defaulting on its debt in the foreseeable future?

Mr. BERNANKE. Not unless Congress decides not to pay, which I do not anticipate. No, I do not anticipate any such problem. I do not anticipate any downgrade. Of course, there are real long-term budget problems that need to be addressed.

The CHAIRMAN. I agree with that. If you can get enough risk premium on treasuries, buy them.

Now, the gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. Chairman Bernanke, I think Chairman Frank mentioned the deficit in passing and the debt, and that is what I want to ask you about. Really, to me, that is the elephant in the room.

Our debt is going to double in the next 5 years, triple in the next 10 years, and is fueled by historic deficits.

I heard this morning on TV that we have in many cases across the United States this year, children and even adults who are kind of walking out on the thin ice, and they walk out maybe day after day, and they get some comfort that nothing happens. Thin ice is dangerous. I submit that this type of budget path is dangerous and the deficits we are running are dangerous.

I would ask you, number one, I do not believe our present budget path is sustainable, so my first question to you is, is our budget path sustainable, and second, is there a need for what I would consider an urgent need for the Congress—you said it was up to the Congress to come up with a concrete plan to change that budget path, and do you believe there is an urgency in that?

Mr. BERNANKE. Congressman, as to sustainability, you are talking about the medium-term structural deficit that remains even after the economy is returned close to more normal levels of activity, estimates of the structural deficit range from 4 percent by the OMB to up to 7 percent of GDP in some scenarios run by the CBO.

Those numbers are above a sustainable level. I think in order to maintain a stable ratio of debt to GDP, you need to have a deficit that is 2½ to 3 percent, at the most.

I think yes, under current projections, we have a deficit and a debt that will continue to grow, interest rate costs will continue to grow.

I do think it is very important that we begin to look at the path, the projectory of the deficit as it goes forward, and there could be a bonus there to the extent that we can achieve creditable plans to reduce medium- to long-term deficits, we will actually have more flexibility in the short term if we want to take other kinds of actions.

Mr. BACHUS. The current budget path is not sustainable, is it?

Mr. BERNANKE. Given the numbers that the CBO and the OMB have projected, that is right.

Mr. BACHUS. It may be upon us sooner than we think, is that a good analogy that I have used, of walking on thin ice?

Mr. BERNANKE. Yes, sir. That is true. It is not necessarily just a long-term issue because it is possible that bond markets will be-

come worried about sustainability and we may find ourselves facing higher interest rates even today, given that concern.

Mr. BACHUS. Is it critical that we have a long-term plan and we have it now?

Mr. BERNANKE. Yes, I think it is very important. I realize it is extremely difficult. I do not underestimate in any way how difficult it is. It is also difficult to address issues which are still a few years away. I understand that as well.

It would be very helpful even to the current recovery to markets' confidence if there were a sustainable creditable plan for a fiscal exit, if you will.

Mr. BACHUS. If we do not address them now, I am not sure we can address them in an effective way 2 or 3 years from now or 4 or 5 years from now.

Mr. BERNANKE. It will become increasingly difficult because the cuts you will need to make will be even sharper or the tax increases even sharper.

Mr. BACHUS. I very much appreciate your testimony. I do believe you have addressed many of the concerns. I am happy that you mentioned the legislation that we passed in a bipartisan way has been an important tool. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you. I wanted to welcome you back to the committee. In response to a question that Chairman Frank asked, you made it clear that you do not want to meddle too much in what the Congress does on these things, and I am not going to ask you to stray over there.

I am more interested in what I perceive to be as reading between the lines of what you said, that you think the Fed itself has used all the tools that are available to the Federal Reserve to help facilitate job creation, actually probably more than would normally be done to facilitate job creation and create maximum sustainable employment since you do not really have a lot of concerns about the other part of the dual mandate, which is price stability.

Am I reading that correctly or are there other specific things that the Fed tool kit might allow the Fed to do to create the environment for more job creation?

Mr. BERNANKE. I think one set of tools that we have that we continue to work on as regulators is to try to get credit flowing again. We know that small business lending is closely tied to job creation. We know there are problems with bank lending to small businesses.

I do not know if you want me to take your time to go through some of these things, but we are collecting more information. We are doing more consulting. We are trying to train our examiners. We are trying to do everything we can to make sure that creditworthy small businesses can get credit and banks would be willing to take a second look at small businesses to make sure they have access to credit.

Mr. WATT. I presume that will be the subject of testimony by folks at the Friday hearing primarily, so I will not ask you to elaborate more on that in this context.

What other kinds of things in your tool kit might be considered or actually I guess maybe the question I should be asking is, are

the short-term consequences of anything you might use in your tool kit, the short-term benefits, worth the long-term consequences, or do you think the Fed really has done everything it should be doing other than trying to facilitate credit, as you just mentioned, in terms of monetary policy, the emergency steps you have taken?

Are there other things you could prudently do, I guess is the question, to facilitate job creation?

Mr. BERNANKE. As you point out, we have extremely accommodative monetary policy with very low interest rates and also large purchases of securities to expand our balance sheet. That is a very accommodative supporting recovery, supporting job creation.

The FOMC is going to have to continue to evaluate whether additional stimulus would be necessary, depending on how the economy evolves. We will continue to look at that.

Mr. WATT. You are kind of in the same posture that we are in on the other side, your policies are creating some stresses on your own balance sheet that over time might have some consequences and you have to get out of it, and what you are saying is we need to be looking at those long-term consequences of more debt and more deficits so that we have an exit strategy to get back to a more normal kind of fiscal policy at the same time you are getting back to a more normal monetary policy.

Am I misstating that?

Mr. BERNANKE. Not at all. One of the greatest challenges of the extraordinary policies that we have both taken is at some point, we want to return to a more normal stance, and finding a way out that is creditable and understandable and clear is very important for confidence.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Paul.

Dr. PAUL. I thank you, Mr. Chairman. The Federal Reserve Transparency Act, which has passed the House already, is something that the Federal Reserve obviously has been opposed to, and one of the reasons they are opposed to it, as I understand it, is it would politicize monetary policy, which is not what the bill actually does.

The other reason they give is that if Congress had any subtle influence, they would inflate more than the Federal Reserve might want to. It is sort of ironic, the Federal Reserve kept interest rates too low for too long and the consensus now in the financial community is that is true, interest rates are still down at 1 percent, hardly could the Congress influence the Federal Reserve in a negative way by causing them to inflate even more.

There has been a cozy political relationship between Congress and the Federal Reserve, although the Congress has been derelict in their responsibilities to perform oversight.

When it comes to debt, the Fed is there. They can monetize the debt and keep interest rates low. The Congress can keep spending and get re-elected. They do not have to raise taxes so the Fed can act as a taxing authority. You print the money, dilute the value of the money. Prices go up and price inflation is a tax.

When people pay a lot more for their medical care than they used to, they ought to think about the inflationary tax.

Also, the Fed accommodates the Congress by liquidating debt, by debasement of the currency, the real value of the money goes down, the real debt actually goes down.

In many ways, the Congress and the Fed do have a pretty cozy political relationship.

I would like to get to more specifics on the transparency bill because it has been reported in the past that during the 1980's, the Fed actually facilitated a $5.5 billion loan to Saddam Hussein, who then bought weapons from our military industrial complex, and also that is when he invested in a nuclear reactor.

A lot of cash was passed through and a lot of people supposed it was passed through the Federal Reserve when there was a provisional government after the 2003 invasion. That money was not appropriated by the Congress, as the Constitution said.

Also, there have been reports that the cash used in the Watergate scandal came through the Federal Reserve. When investigators back in those years tried to find out, they were always stonewalled, and we could not get the information.

My question is, you object to this idea that I would say give us 6 months, after 6 months, we could find out what we are doing, but what about giving you 10 years?

Would you grant that the American people deserve to know whether the Federal Reserve has been involved in this, and what kind of shenanigans they are involved in with foreign countries and foreign central banks, and find out possibly you are working now to bail out Greece, for all we know.

Would you grant that after 10 or 15 years, the American people deserve to know? It seems if the Fed was not involved with this at all, it would be to your advantage to say no, we do not do stuff like that. Why could we not open the books up 10 years back and find out the truth of these matters?

Mr. BERNANKE. Congressman, the specific allegations you have made, I think, are absolutely bizarre, and I have absolutely no knowledge of anything remotely like what you just described.

As far as the 10 years, after 5 years, we produce complete transcripts of every word said in the FOMC meetings. You have every word in front of you.

Dr. PAUL. Can we get the results of every agreement, every loan made, every single thing to foreign governments?

Mr. BERNANKE. Yes, sir.

Dr. PAUL. There has been a lot of information, when this came out in the early years, they did have an effort and the Federal Reserve never participated in this. It is easily covered up.

I think eventually, because the system is not viable and that it is this cozy relationship, that we will get to the point where something will have to be done about this financial system, so as long as we continue to do this, this cover up, and quite frankly, I do not believe that the real effort to facilitate some of these things that have been done in the past would become available to us because it is in the interest of the Federal Reserve to make sure that the people do not know.

Right now, today, is it quite possible, have you talked with any international groups about possibly participating in a bailout of Greece?

Mr. BERNANKE. I have not.

Dr. PAUL. The Federal Reserve under the law is capable of doing this. Is it not correct that the Fed can buy debt of other nations, and under the Monetary Control Act of 1980, is that not permissible?

Mr. BERNANKE. Yes, that is true, but we have no plans whatsoever to be involved in any foreign bailouts or anything of that sort.

Dr. PAUL. If they did, it certainly would be to our advantage to know about it. I yield back.

The CHAIRMAN. The gentleman's time has expired. I recognize the gentleman from Pennsylvania.

This committee will look into the allegations that under Presidents Reagan and Nixon, the Federal Reserve was engaging in those activities, and the gentleman said during the 1980's, the Federal Reserve lent money to Saddam Hussein and during Watergate, they did this, and I agree we should look into what might have happened under those two Presidencies.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, I am not going to take all of my time, because I know we have the interest of the other committee members.

I am particularly interested in some of the communications we have had recently on the commercial real estate problem. Could you give us your assessment of what that potential problem is today and where it can grow and if there is any actions we in the Congress should take in anticipation of getting a second hit in the economy?

Mr. BERNANKE. Congressman, it remains probably the biggest credit issue that we still have. Yesterday, Chairman Bair talked about a big increase in the number of problem banks, a great number of those banks are in trouble because of their commercial real estate positions, both because the fundamentals, shopping center vacancies, things of that sort, have been worsening, and because of problems in financing, there are a lot of troubled commercial real estate properties, and they are causing problems for a lot of banks, particularly small- to medium-sized banks.

We are watching that very carefully. The Fed has done a couple of things here. We have issued with the other agencies guidance on commercial real estate, which gives a number of ways of helping.

For example, instructing banks to try to restructure troubled commercial real estate loans and making the point that commercial real estate loans should not be marked down just because the collateral value has declined. That depends on the income from the property, not the collateral value.

We have also had this TALF program, which has been trying to restart the CMBS, commercial mortgage-backed securities market, with limited success in quantities, but we have brought down the spreads and the financing situation is a bit better.

We are seeing a few rays of light in this area, but it does remain a very difficult category of credit, particularly for the small- and medium-sized banks in our country.

Mr. KANJORSKI. Is there anything that you would suggest that the Congress get involved with or this committee now in anticipation of any problems that may occur?

Mr. BERNANKE. I do not have a specific suggestion. I would be happy to think about that.

Mr. KANJORSKI. Thank you, Mr. Chairman. I yield back my time.

The CHAIRMAN. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Mr. Chairman, congratulations on your reappointment.

I want to go back to page nine of your testimony where you said that the Federal Reserve has been playing a key role in international efforts to tighten capital and liquidity requirements for financial institutions, particularly systemically critical firms.

Can you give me an idea of who you think the international systemically risky firms are?

Mr. BERNANKE. One of the issues that we will have to address, for example, if the regulators agree there should be additional capital on systemically risky firms, then the question will be how to identify those firms.

Presumably, we will look at things like their size, their complexity, their interconnectedness, and the kinds of services they provide to the financial system.

We have not addressed that question. We do not have a list or anything like that. It is also possible we might want to do it in kind of a gradated way so that the bigger and more complex the firm, the more capital it needs to hold, as protection for the system, so we do not have the "too-big-to-fail" problem that Congressman Paul was talking about.

Mr. NEUGEBAUER. I also heard you say you are now going back internally and looking within your organization as to what are the things we missed, what should we have been looking at, and moving forward.

I think one of the questions—I hear almost all of your former colleagues keep using the word "capital," and I truly believe if you want to regulate the financial entities, capital is the primary way to do that.

Looking forward, what is going to be the appropriate leverage level that we should allow our large financial institutions to have so they will have a shock absorber moving forward? Some of these entities were leveraged, 30, 40, big numbers.

As the Federal Reserve Chairman, primary regulator for many of these entities, what is the appropriate leverage?

Mr. BERNANKE. Congressman, everybody agrees with what you just said, which is more capital is needed. The Federal Reserve representing the United States has been working with other countries, the Basel Committee and in other contexts, to try to develop new standards.

We have implemented a few of them. For example, for market trading. At this point, we have not completed the whole process of developing higher, more stringent capital standards for large firms.

A proposal has been put forward which is now being tested. Banks are being asked to evaluate how much capital they would have to hold under these more stringent standards, so we can get a sense of what the implications would be for the leverage ratio.

I do not know that number yet. We are trying to figure out what will be safe. It would depend on the composition of the assets the bank has. The riskier the assets, the more capital you should have.

We are working to try by the end of 2010 to have a very concrete proposal that each country would then have to decide whether to adopt or not.

Mr. NEUGEBAUER. You would agree the standards we had before evidently did not work?

Mr. BERNANKE. Clearly, they did not. I would add the liquidity issue also, that during the crisis, many banks were technically well-capitalized, but they did not have enough cash on hand to meet the run that was coming on them. Higher liquidity is also a part of this.

Mr. NEUGEBAUER. One of the concerns I have is in some of these entities, I have seen some deleveraging, but I have not seen a lot of deleveraging.

I am wondering if it is not better sooner rather than later for the Fed to develop these guidelines and standards and start asking the entities that you are regulating to start ponying up either more capital or deleveraging their balance sheets because certainly the American taxpayers do not want another round of this.

Do you have a time line in mind where we could anticipate hearing that the Fed is taking action to increase the capital standards or setting some new capital standards?

Mr. BERNANKE. As I said, I think around the end of the year we will have some formal standards, but we have been very much involved in pushing banks to raise more capital.

That was one of the outcomes of the stress test we did last spring, that U.S. banks raised a very substantial amount of capital, and that has been very helpful in restoring confidence for the banking system.

Mr. NEUGEBAUER. Are you concerned about what is going on in the European Union right now with Greece and some of the other countries within the Euro, their levels of debt, are those countries going to have to step in and back them up, and the implications of what the disruption within the European Union might impact the United States?

Mr. BERNANKE. There are very serious challenges there involving not only fiscal issues but competitiveness issues because of the single exchange rate.

We have talked to the European Union leaders. They are obviously very focused on getting this problem solved. They are working closely with Greece, which has proposed a substantial fiscal consolidation.

We are keeping an eye on it. The Europeans, of course, it is most relevant to them and they are most exposed to those problems. They are very focused on trying to get them under control.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much. I would like to thank Chairman Bernanke for being here today.

Starting with your discussion on page four, "In addition to closing its special facilities, the Federal Reserve is normalizing its lending to commercial banks through the discount window," and you go on to talk about your new Federal funds rate and discussion about why you have done this, and encouraging banks to go to the private market for investments.

You say further in this discussion that these adjustments are not expected to lead to higher financial conditions for households and businesses. The last thing I heard before I came here this morning was a prediction by some of the analysts on television that in about one month, we can expect there will be an increase in interest rates on mortgages and home loans.

Everybody that I talked to really believes that this change that you have made in the Federal funds rate is what is going to trigger that. Is that true? Did you give any thought to this? How can you guarantee that it will not?

Mr. BERNANKE. Congresswoman, it is not the Federal funds rate, it was the discount rate, the rate at which we lend on a special overnight basis to banks, we cut that very low because of the financial crisis.

We wanted to make sure that banks had access to lots of liquidity in case there was a run on the banks. Now that there is easy access to private markets, they do not need that kind of help any more, so we have just slightly reduced the subsidy we are giving to banks.

It has nothing to do with the Federal funds rate or the overall stance of monetary policy. It has to do with normalizing our extraordinary support for the banks and the financial markets.

We do not anticipate that action having any implications—

Ms. WATERS. Let's be clear. The change that you have made, no matter how slight it is, at the discount rate, will increase the amount they have to pay for their loans, the banks; is that right?

Mr. BERNANKE. It is a very small amount in terms of the amount they borrow.

Ms. WATERS. I understand that. What I am trying to understand is, is there a connection between the increase in the amount of money they have to pay and household interest rates?

Mr. BERNANKE. I do not think there is any material—

Ms. WATERS. Can you assure us that will not happen?

Mr. BERNANKE. I think it is extremely unlikely, and if it were to happen, we would look at it. I do not think there is any connection.

Ms. WATERS. What I am worried about is you still have a lot of mortgages out there, adjustable rate mortgages, with 3 percent margins on them. If in fact this is going to trigger an increase, we are going to have more foreclosures because the interest rates are going to be higher. That is what I am worried about.

The predictions are that we have not seen the end to these foreclosures, that with the loans that were extended, people are going to be more at risk. I do not want to see the interest rate increase on these adjustable rate mortgages.

Mr. BERNANKE. There is no linkage between adjustable rate mortgages and the discount rate. It is linked to the Federal funds rate, which we have said we anticipate will be at an unusually low level for an extended period.

Ms. WATERS. I want to be clear for this committee that the actions you have taken have no connection to the possibility of an increase in the household interest rates, we do not have to worry about that; is that right?

Mr. BERNANKE. The reason we took the action was again to reduce the subsidy that we are giving to a small number of banks—

Ms. WATERS. When you reduce the subsidy, that means they have to pay more money; is that right?

Mr. BERNANKE. I do not think there will be any effect on consumers.

Ms. WATERS. I beg your pardon?

Mr. BERNANKE. I do not expect any effect whatsoever on consumers.

Ms. WATERS. You do not expect them to pass on that cost to the consumers?

Mr. BERNANKE. No, because it is very small, and I do not think it will affect it.

Ms. WATERS. Let me just ask, you talked about the 10 percent unemployment rate. That does not really reflect what is happening in poor rural communities and African-American communities and in Latino communities where the unemployment rates are up as high as 16.9 percent in African-American communities and even higher in some of these poor rural communities.

When you describe this jobless recovery, I think it would be important to talk about these communities that are not represented by the 10 percent description that you give.

What do you have to say about that and is there anything you can recommend that we could do to deal with this problem?

Mr. BERNANKE. You are absolutely right that minority communities in particular have much higher unemployment rates than the overall average, and that is a terrible problem.

Monetary policy cannot really do much about those distinctions. I think those are issues that Congress needs to address if you are inclined to do so.

I can only agree with you that it has not only short-term implications in terms of family income and so on, as I talked about in my testimony, it has long-term implications for skills, for workforce attachment, for wages and employability.

It is a very long-term problem. I can only agree with you 100 percent that it needs to be addressed.

The CHAIRMAN. The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman. Welcome, Mr. Chairman, back to our committee, and congratulations on your reappointment.

The CHAIRMAN. Will the gentlewoman suspend for a minute?

Mrs. CAPITO. Yes, I will.

The CHAIRMAN. Someone has his or her microphone on and we are getting these rumbling noises. Would members please make sure to shut their mikes off unless they are speaking? Sometimes, they pick up these noises. Thank you.

The gentlewoman has 5 minutes, she can start from scratch.

Mrs. CAPITO. Thank you. On page three of your testimony, you talk about contrasting larger lending institutions with smaller lending institutions, and you say bank lending continues to contract, reflecting both tightened lending standards and weak demand for credit and uncertain economic prospects.

My question is that I have heard from our community bankers that they have the capital to lend but they are getting conflicting messages from regulators.

How can we ensure prudent lending and capital levels while working with these institutions but to expand on the question, too, they have the capital to lend, but creditworthy customers are not the ones coming in the door looking for expansion of their business because they lack confidence in where the economy is now, where we will be a year from now.

That is my first question. Thank you.

Mr. BERNANKE. Well, there are two separate issues there. It's true that because the economy is weak that some borrowers are not in the market for credit and that's one of the reasons why bank lending is down.

The other issue, though, which I think you began with is that in situations where there is a creditworthy borrower who would like credit, we want to make sure that they get credit and we have been very focused on that issue.

Mrs. CAPITO. But haven't had the results that—

Mr. BERNANKE. Well, we have been working on it very hard. We have, for example, increased substantially our information-gathering so that we can make an assessment of how many loans are turned down, what is the rate of loss on small loans versus large loans.

We added questions to the National Federation of Independent Businesses Survey asking small firms about their experience with borrowing and so on. So we are trying very hard.

We have also our reserve banks around the country currently having a series of summit meetings with community leaders, development organizations, small business lenders, and small companies to try to figure out what the problems are. So we are actively going out and learning about the situation the best we can.

It's very difficult because there will be some cases where tighter standards are justified because of the weakness of the economy and the weakness of the borrower's condition. We just want to make sure that when there is a creditworthy borrower that they can obtain credit.

Mrs. CAPITO. Well, thank you for addressing that. I think it's extremely important in the smaller communities, more rural communities and States of that nature.

My second question is a completely different question. We have lost four million jobs and—but over the longer span of time we have picked up four million jobs, government jobs, and when I went on the recovery.gov Web site to see where jobs were created or retained according to that site, in my 2nd Congressional District the largest zip code was the State capitol, implying and reasonably so, that these were State jobs that are being retained or created.

My question is in a larger sense what do you—how do you feel this will impact our economy if this trend continues, and for me it's a source of concern because it seems like our private sector manufacturing jobs, as they move down, our government jobs obviously to me that says it's more government, more government spending, more government obligations.

Mr. BERNANKE. Well, actually, we have lost somewhere in the vicinity of seven to eight million jobs on net, including government jobs, since the beginning of the recession. So obviously the total employment is very significantly down.

Some of those government jobs are bureaucrats. You're thinking of those kinds of jobs, but two of the industries that have actually added jobs during the recession are health and education and many teachers are technically government employees. So some of that may be showing up from those particular areas which are growing very quickly.

But certainly, as a general proposition, we want the private sector to be healthy and to be supporting the overall economy and we don't want to create too much overhead of government jobs that are not productive in some direct sense.

Mrs. CAPITO. Thank you.

The CHAIRMAN. The gentlewoman from New York, the Chair of the Joint Economic Committee.

Mrs. MALONEY. Thank you. Thank you so much, Mr. Chairman. Thank you very much, Mr. Chairman, and congratulations on your renomination, and I believe we have been very fortunate to have at the helm during this financial crisis a scholar, a professor who has dedicated his life work primarily to studying the Great Depression, writing about it, and I believe the Fed came forward with many creative unconventional responses to help us move out of this crisis.

I also want to thank you for your leadership on many consumer issues that are important to this committee and to this Congress. The CARD Act, the Credit Cardholders' Rule that helps consumers, will put billions back into consumers' hands and the rule that came from the Fed was incredibly helpful in putting a clear logic forward and helping us win passage in this House, also the rule on overdraft is very welcomed and very important to consumers.

In the Credit Card Bill of Rights, one of the items that will be enacted in August 22nd is the Federal Reserve's reaction and analysis about charges that may be too onerous and how you would make them fair, and could you comment on what your work is in that area, when you intend to have that ready for us to see, and how you intend to approach this challenge?

Mr. BERNANKE. We anticipate having those rules out very shortly, in a few weeks, and you will be able to give us your views on them at that time.

We wanted to be sure to get them out in time so that the law would go into effect as Congress dictated and so there will be no delay in the implementation of these rules, even though they have been a couple of weeks later than we expected in getting them out.

So we are working to have a comprehensive set of rules that will give a set of criteria, in particular if someone's interest rate has been raised for some reason because they're perceived as being a greater risk and 6 months later the condition has been corrected, we are looking at the rules under which the interest rate ought to be returned to the normal or the previous level. That's one of the issues that we're considering.

But we anticipate having those out very shortly and we don't expect any delay in the implementation.

Mrs. MALONEY. As we dig our way out of this recession and we are definitely trending in the right direction, the month that President Obama took office, the last month that the former President was in the office, we lost well over 770,000 jobs. This past month,

under President Obama, we lost 18,000 jobs. We're definitely trending in the right direction.

The Fed is now looking at ways to really move back to a normal economy and some people—one article I was reading last night felt that you should invest more in Treasury notes as opposed to other actions that you're taking.

Could you comment on the steps you're taking to really move our financial institutions and our total economy into the proper functioning expanding economically and other ways to help the people of America?

Mr. BERNANKE. Yes. We have two broad sets of policies, roughly speaking. One was a set of special facilities, lending facilities that were intended to stabilize our financial system which obviously was extremely disrupted by the crisis. Those facilities have been quite successful. They have helped stabilize the money market mutual funds, commercial paper market, the repo market, many other important financial markets.

With the improvement and stabilization of those markets, we have been shutting those down. So many of them were shut down on February 1st and this was a question Congresswoman Waters asked about the discount rate and so on. So we believe that, as those financial markets are normalizing, we can begin to reduce that source of support.

The other approach, the other policy, set of policies we have is monetary policies intended to support the recovery which includes the low interest rates and the purchases of mortgage-backed securities and treasuries. Those remain at a very accommodative level.

It is true that we will stop buying new mortgage-backed securities at the end of this quarter, but we will continue to hold one and a quarter trillion dollars of agency mortgage-backed securities and that taking that off the market itself will keep mortgage rates below what they otherwise would be.

So we believe that there will still be stimulus coming from our holdings of those securities as well as our low interest rates. So we think the economy as opposed to the money markets, for example, still requires support for recovery.

Mrs. MALONEY. Well, we are trending in the right direction. My time is up.

Thank you for your public service.

Mr. BERNANKE. Thank you.

The CHAIRMAN. The gentleman from California, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman. Mr. Chairman, I believe across this country, everywhere you go, jobs is Number 1. You have referred to that and also to the deficit.

I want to follow up on both those topics, but I want to go back to what my colleague from West Virginia was talking about, four million more jobs in government than in manufacturing. You talked about that, but you cannot sustain that if the taxpayers are paying for that and the lack of manufacturing, how you would be able to grow.

You talked in your testimony here of unemployment being at 10 percent. In my State, it is higher. In my congressional district, it's higher. Throughout the Central Valley in California, there are some places at 40 percent unemployment.

But even a stronger telling in there, you said 40 percent of the unemployed have been out of work 6 months or more, nearly double from a year ago. Now you did say these government jobs, there are some bureaucrats, but there's—the growth was in education and in healthcare, but there has to be some commonsense because if you go down the road here, the Federal Government, there are more than 100,000 people who work there who make more than $100,000. The money is probably better used inside the classroom.

But I'm trying to find where there are some ways that we can create jobs quickly with low cost, rolling back regulation, but you said in your testimony here, you talked about the international, that the international was recovering—if I state it right within there, you say, "International trade supported by the recovery in the economies of many of our trading partners is rebounding from its deep contraction of a year ago."

Now there are three trade agreements that are sitting here, Panama, Colombia, and South Korea. The President has said that if you increase U.S. exports by 1 percent, it would create over 250,000 jobs and hence change the jobs we are creating from government to others.

Do you agree that 1 percent, and they say with these three trade agreements it would give you that 1 percent, would it create 250,000 new jobs?

Mr. BERNANKE. I don't know that number. I would have to look at that number, but certainly opening up trade creates opportunities for us to export and that ought to create jobs. I'm quite sure it would.

Mr. MCCARTHY OF CALIFORNIA. And it would not cost anything more but it would create jobs that weren't government-related?

Mr. BERNANKE. It ought to improve the division of labor between our different countries. Each country can be more productive, should raise our standard of living, and I expect would create jobs, as well.

Mr. MCCARTHY OF CALIFORNIA. If I could just touch base on what our ranking member talked about earlier because we have had many discussions with you and your past profession, the study of former countries and some of their downfalls.

The national debt and the budget deficit, you have told us time and time again that you cannot sustain a budget deficit over 2½ to 3 percent of GDP, and you stated that earlier and I wrote down a few words that you refreshed. You said if we were able to get a fiscal exit from this, it would actually help the current recovery, is that correct?

Mr. BERNANKE. Yes.

Mr. MCCARTHY OF CALIFORNIA. Looking at the current budget that is proposed, does that reflect the commitment of changing the growth curve of our budget deficit or our national debt?

Mr. BERNANKE. Well, as I said earlier, the projections of 4 to 7 percent deficits from 2013 to 2020 and increasing after that, I think everyone would agree, including the President, that is not sustainable and that we need to address those numbers and get them down in the out-years.

Mr. MCCARTHY OF CALIFORNIA. I heard you say that, and I'm trying to say here as a Member of Congress looking at a budget today,

hearing your words that you have told us time and time again and every economist says it, that you cannot sustain this, watching our national debt of GDP go up almost to the highest level outside of World War II, especially at the end of this decade to be 77 percent.

What do we do today? Your quote earlier said, "would help the current recovery if we were able to sustain that." So looking at the current budget, does it give us the change needed in any shape or form?

Mr. BERNANKE. Well, it's not sufficient to look at this year's budget, if that's what you mean. I mean, you have to look at the next 10 years and—

Mr. MCCARTHY OF CALIFORNIA. Yes. But we're sitting in a place where we vote where we look today. We all see 10 years and where it's going. We all realize that this is putting us in a place that gives us great hardship. So our actions have to be now and your comment says it helps the current recovery if we take action, as well.

So the current budget that I see does not give us that, and I'm asking you, do you see it as helping us in this fiscal crisis or does it expand the deficit further?

Mr. BERNANKE. I think it would be helpful for the current situation if the Congress and the Administration could provide a plan which shows how the deficit will fall to this 2½ and 3 percent level, at least, over the next 10 years. I don't know exactly which programs, what taxes, what changes you would make, that's certainly up to Congress, but even a strong effort would be probably good for confidence.

Mr. MCCARTHY OF CALIFORNIA. It would be good for the future but even be good for the recovery. I'm not asking you to pick departments.

Mr. BERNANKE. It would increase confidence, lower expected tax rates, and lower real interest rates.

The CHAIRMAN. The gentleman's time has expired.

Mr. MCCARTHY OF CALIFORNIA. I thank you, Mr. Chairman.

The CHAIRMAN. And we're trying to be fairly strict on the time because we have a vote coming up and I understand that Chairman Bernanke needs to be—we have assured him that he'll be out by 2 o'clock.

So the gentleman from Illinois is recognized.

Mr. MANZULLO. Thank you. Congratulations on your re-election, Mr. Chairman. You got reappointed, but you had to get elected, just like we do. It was a vote count.

Chairman Bernanke, the FDIC reported yesterday that bank lending in 2009 fell by 7.5 percent or $587 billion, $587 billion, and the Wall Street Journal, its headline today said it was epic, the decline. There's a chart behind.

Why is bank lending falling so dramatically? It has fallen, I believe, because we're forced to hold greater capital reserves, given the rising default rates on commercial real estate.

Up on the committee room TV now is a chart from the most recent Congressional Oversight Panel report which shows the value of delinquencies on CRE loans has increased 700 percent since the first quarter of 2007. You'll notice from the chart behind you, Mr. Chairman, that if the trend continues, the rate of CRE loans will soon be literally off that chart.

The dramatic increase in delinquencies to me is really approaching a tsunami, threatening our local communities and banking system. It's estimated to peak between 2011–2012 with over $300 billion in CRE debt expected to mature each year. As you know, the CRE market is huge. It's $3.5 trillion of the total debt. It's about $1.7 trillion held by banks and thrifts. Much of this debt is held by community banks across the country that have survived the first part of the tsunami, the mortgage default crisis, but now are being threatened by this one.

The FDIC yesterday informed us that they're adding 450 banks to the Troubled Bank List, more than doubling the number from the start of 2009. Many are small lending institutions that have invested in their communities for decades.

Chairman Bernanke, I just held a hearing January 21st on the epidemic of bank failures focusing on the failure and seizure of a great Chicago community institution, Park National Bank. I would rather not have more hearings in the coming year on the autopsies of what have been rather good banks.

I want to focus on how we can help these good banks and how we're getting back to lending. So how much do you think of the coming tsunami of these loans, $1.7 trillion held by our local banks, loan defaults are going to harm our communities and local banks, and what have you done about it and what future plans do you intend to make about it?

Mr. BERNANKE. Well, it is a serious problem and as I mentioned earlier, the commercial real estate losses, loan problems are probably the biggest threat at this point to our smaller and regional banks and, as you point out, if those banks have their capital depleted or if they go out of business, that's going to affect the supply of credit and so that affects our economy, as well. So that's a very important problem.

I think, from the Federal Reserve's point of view, there are basically two kinds of things we can do. First of all, we can support the economy and as the economy strengthens, that makes people go shopping in shopping malls or willing to—new employment fills up office buildings and so on and that helps solve that problem and so obviously we're trying to support the recovery.

The other thing we can do is to try to work directly in the market for CRE and we have done some things along those lines. We have had this program called the TALF which has been successful in getting the interest rates on commercial mortgage-backed securities down somewhat, reduced those spreads.

We have issued guidance on commercial real estate loans where we are trying to work with banks so that they can restructure troubled loans so they can continue to be performing, perhaps at a reduced level, but continue to be providing income. So we're looking for those kinds of solutions.

Those supervisory approaches and monetary policy approaches, those are our two main tools.

Mr. MANZULLO. Your program that you mentioned is going to end in June. Are you going to renew the program?

Mr. BERNANKE. In June. Well, we will be evaluating the situation. There is progress being made in those markets. As I said, the

spreads have come down quite a bit and some deals are being done outside of the Federal Reserve's program.

Mr. MANZULLO. I appreciate all that you're doing with the regulators, but, you know, the Park National Bank that we referred to really lost its shirt with Fannie and Freddie. The Federal Reserve and everybody said buy it, we're going to give you extra credit if you do it, and they did and now they're out of business because they followed the recommendations of many of our government financial regulatory institutions.

So I really think that we shouldn't underestimate the coming tsunami of this debt in commercial real estate. I hope that the actions that we take are going to fill those office buildings, but I would like to have more discussion with you about other steps that I think we take, other than hoping that what we're doing is going to fill those office buildings.

Mr. BERNANKE. We're following it very closely.

Mr. MANZULLO. Thank you.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Delaware, Mr. Castle, is recognized.

Mr. CASTLE. Thank you, Mr. Chairman. Chairman Bernanke, like many others here, probably all of us, I'm very concerned about the job situation in the United States and we can argue politically whether the Stimulus Program has worked well or not.

Mr. Zandi, an economist, yesterday indicated that the jobs that were created were probably to some degree temporary in that we funded governments so they could keep on employees for a period of time and various capital projects that will expire at some point or another. So we still have a continuing problem, and I have had a couple of job fairs in my State and I have been surprised both at the number of people who have come out for that and the backgrounds of some of these people. It's not the usual unemployed, it's people with college degrees, even graduate degrees, who are unemployed at this point.

I see that the lending by banking institutions has fallen by some 7.5 percent in 2009, and my question to you is, is there anything that you as the head of the Fed or the Fed itself or us as Members of Congress could be doing to help with the employment circumstance?

My further question is what is happening in this whole bank lending? I mean, we have put a lot of—we, being both the TARP Program and the Federal Reserve, have put a lot of money into banking institutions, primarily larger banking institutions, and the theory was that they're the ones who are going to lend to the other commercial banks who would then lend to the business people on main streets throughout America and that somehow seems to have not connected.

The lending is down for a lot of the reasons you're talking about, the commercial real estate issues and various aspects like that which I understand, but what is it that we could do to make sure that the lending does pick up so that jobs can be created and, perhaps as an economist beyond even the Federal Reserve, what else should we be doing differently or considering doing in terms of helping with employment, by we meaning Congress and the Federal Reserve?

Mr. BERNANKE. Just to comment quickly on the TARP money, there were two objectives of the TARP money. One was to stabilize the banks and the second was to give them capital on which to base their lending. Unfortunately, the politics was very bad, as you know, and the public and the Congress have stigmatized that money and the banks therefore have done the best they can to pay it back as quickly as possible and so basically all the big banks have paid back their TARP money now and so it's no longer available to provide support for credit. So that's unfortunate.

Another thing I would just like to mention is that ironically, one of the reasons that we lost so many jobs is that American firms were incredibly efficient in reducing their costs in the depths of the crisis. Many other countries were not as effective at cutting costs and what we found here is that we have had enormous increases of productivity, which bodes well for the long-run, but obviously in the short-run, means that there have been more job losses than otherwise would have been the case.

It's partly for that reason that it's hard to judge how quickly jobs are going to come back. It may be that firms have already cut to the bone and they cannot get any further reductions in their costs and as growth comes back, as we're seeing, they'll be forced to bring back workers more quickly than we now anticipate. So that's something to be looking for.

From the Fed's point of view, I have already mentioned that our jobs program consists of support of monetary policy and our supervisory policies to try to get credit flowing. From Congress' point of view, there are a range of possible fiscal actions. Again, I hesitate to try to recommend specific ones, but I'm sure you know the menu of things that you could do which could create jobs.

But, you know, unfortunately, there's no silver bullet here.

Mr. CASTLE. Well, I realize there's no silver bullet. I just would hope that the Fed would continue to monitor very carefully the banking institutions—

Mr. BERNANKE. Of course.

Mr. CASTLE. —and what they're doing with the money they get and either return of capital on the repayment of loans or the issuance of lending out to other banks.

Let me ask a different question. Have Fannie Mae and Freddie Mac served their purpose? They are very expensive to this government at this point and the business of packaging mortgages and being able to sell them off could be done perhaps differently than that and, you know, this goes back—maybe this is a question I should have asked 10 years ago, I suppose.

But the bottom line is that should we be looking at some different way of dealing with the financing of mortgage structures in this country or do you still believe that they serve that basic purpose and we should leave them intact, even if they have the problems they seem to have?

Mr. BERNANKE. The Federal Reserve, I think, was one of the more vocal commenters on Fannie and Freddie for many years and we were very concerned about their stability and whether they had enough capital to support those large portfolios they had and it turned out they didn't and we're paying the cost of that right now.

I think we would be very cautious about supporting a return to the existing structure where you have this potential conflict between private shareholders and the public objectives.

I think there are alternatives and I provided some of them in a speech I gave a year-and-a-half ago and would be happy to provide you, which would be a more stable long-term solution, including either a privatization approach with government guarantees or a public utility approach. Those are two options that you could consider.

The CHAIRMAN. Time has expired. We were going to have a hearing on March 2nd on that very subject. I had to postpone it because there was a major hearing on the fishing industry in my district and I had to fish or cut bait, so I'm going fishing, but also it turned out we had originally thought that would be a day in which there had been votes the day before. It is a day in which there are not votes until that evening and members expressed a lot of interest in it.

We will, on the next available hearing day, have a full hearing on exactly that topic and so, Mr. Chairman, we will be looking for an elaboration of those views, but we had the hearing set for March 2nd on precisely the topic the gentleman asked, not just Fannie and Freddie Mac but its interaction with the FHA and Ginnie Mae and the Federal Home Loan Bank and all of the various strains of housing financing. So we'll get the rest of that answer within 10 days at the latest.

The gentlewoman from New York, the Chair of the Small Business Committee, who will be co-presiding on Friday on a hearing on this recurring important topic of how do we get loans flowing to small businesses which she's been focused on, the gentlewoman from New York.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Chairman Bernanke, you know, you quite well said that economic recovery is tied to jobs creation and we all know that job creators in our country are small businesses, and if you talk to any member in this panel sitting here, they will tell you that each one of us know some creditworthy borrowers who can't access lending and and we know that we have put together all these tools to incentivize lending and we see today's Wall Street Journal with that title about lending, the sharpest decline since 1942.

And I know that your answer to me is going to be, well, that is not under my purview, but if we have tried all these tools and are not producing the success in terms of easing or getting credit flowing again for small businesses, even the loan guaranty by SBA, we have seen 50,000 less loans this year compared to last year and we increased the loan guaranty from 75 to 90, we reduced the fees paid by borrowers and lenders.

So my question to you is, do you think that there is a time, given this economic crisis, for the Federal Government to play a more aggressive role in direct lending in a temporary basis?

Mr. BERNANKE. First, let me just say that this is a Federal Reserve concern because we are bank regulators and I won't go through the list again, but we are trying to get more information to try to make sure that the creditworthy borrowers are able to get credit and we consider it very important.

Indeed, one of the reasons that we value our bank supervisory role is because it provides us with that information and gives us that ability to understand what's happening in that very important market.

In terms of policy, I think there are a number of things that can be done. You mentioned the SBA. There's a proposal to provide capital to small banks that make small business loans.

Ms. VELAZQUEZ. That would be TARP money that has been stigmatized by Congress and by the people in this country. So if it didn't work before, for example, when the secondary market was—we tried to unlock the secondary market by creating under Treasury small business lending facility and it didn't work, they didn't make one loan, if it didn't work then, why do you think it's going to work now?

Mr. BERNANKE. You may be right. But I do know that the proposal is to try to put some distance between the TARP Program and this alternative program, but whether that works or not, I don't know.

But there certainly are some things that you could look at and we will continue to look at it from the perspective of supervision.

Ms. VELAZQUEZ. Okay. Mr. Chairman, you mentioned your concern about real estate losses, and my question to you is if your—the Central Bank is currently in the process of winding down the TALF Facility and without the TALF, what will the Fed do in the event that instability returns in the CRE or small business markets?

Mr. BERNANKE. Well, the purpose of the TALF was not really to solve the whole CRE problem. Its purpose was to try to get the commercial mortgage-backed securities market going again.

I guess it's a little bit of an overstatement to say that it's going again, but we are getting some deals there and the spreads have come in and so that issue has been somewhat reduced in terms of the concern.

I think the real concern at this point is that the fundamentals for hotels and office buildings and malls and so on are quite weak and that's why the loans are going bad and really the only solution there is, first, to strengthen the economy overall and, second, to help banks deal with those problems, work them out.

Ms. VELAZQUEZ. Mr. Chairman, today it has been reported that 25 percent of all mortgage borrowers were underwater, 11 million families in this country.

What is the Fed doing to encourage stability in the housing sector that is so tied to economic recovery in the long term?

Mr. BERNANKE. Well, this is a little bit out of our ballpark, but we did work with Congress and the Treasury in developing the HOPE for Homeowners Program, for example, which has really not met expectations at this point. The structure of that program was to give principal reductions, principal forgiveness. So the main program right now, the HHM Program, is about affordability as opposed to principal reductions.

So right now, there's not a major program. I think the Treasury's Mortgage Program is considering some pilot programs that would include principal reductions.

The CHAIRMAN. Mr. Chairman, I'm going to have to—because you didn't have a lot of time, we would like the rest of that answer in writing. That's a topic to which we will be returning—

Mr. BERNANKE. Okay.

The CHAIRMAN. —and if you want to elaborate in writing on that, we will ask you to do that.

Mr. BERNANKE. All right.

The CHAIRMAN. The gentleman from California, Mr. Royce, is now recognized.

Mr. ROYCE. Thank you, Mr. Chairman, and, Mr. Bernanke, I watched and listened with interest to the opening statements here and let me explain one thing.

Since January of 2007, since every spending bill originates in the House, since January of 2007, we have had Democratic majorities in the House and in the Senate and I was a critic, as you might recall, of Republican spending in 2005 and in 2006, but since 2007, it has been explosive and because every spending bill originates in the House, I think there is some confusion on the part of the public in terms of where the spending comes from, how it originates.

To me, when I first reviewed the Administration proposal, something that struck me was the fact that at no point anywhere in the future does the Administration expect our Nation to have a balanced budget. As we look forward on this graph, at no point, according to its own numbers and presuming an economic recovery, do they expect this to change.

As a matter of fact, the deficits are expected to spike dramatically in 2020. It goes up dramatically in this budget, and I think the failure to operate within our means is plunging our Nation deeper and deeper into debt, something which you see when we talk about the interest expense quadrupling to $840 billion by 2020. It's going to be the fourth largest budget item.

So as you said, Chairman Bernanke, budget deficits, when you're speaking about of this magnitude, as far as the eye can see are simply unsustainable. I think that eventually it occurs to those of us who have been a part of this process that the window to address this problem before it spirals out of control is closing very quickly.

I'm afraid there is a lack of urgency here and here's what I wanted to ask you. First, would you agree that this plan put forward by the Administration is not sustainable and, second, would you concur that in the past, the Federal Reserve has stepped forward, has tried to give direction to Congress very forcefully?

And I remember with respect to Fannie Mae and Freddie Mac, the warnings that came from the Fed where Congress was told you are risking a systemic collapse of the financial system if you don't do something about the overleveraging, the arbitrage that's going on there, the 100:1 leverage, the fact that you have put mandates, Congress has put mandates on these institutions to buy subprime and Alt-A loans. This is a systemic risk.

Now Congress ignored that, but the fact that you forcefully did that did at least alert a lot of people who otherwise wouldn't have been aware of it.

What can you do now in your capacity in order to call it—and this is my second question—in order to call attention to the severity of this? I say this because Mr. Hoenig with the Kansas City Fed

recently said that, "the most dire of the three options is for the Fed simply to print more money," in this speech he gave knocking on the Fed's door. That threatens hyperinflation. So what can be done to really get this point across?

Thank you, Chairman Bernanke.

Mr. BERNANKE. Well, first, let me say that we're not going to be monetizing the debt, but I think everyone understands the basic arithmetic here, that if deficits go on at 3, 4, and 5 percent of GDP and that picture, if you extend it beyond 2020, would probably get worse because entitlement spending, aging society and so on, that you'll get increasing interest payments and it will spiral out of control and the CBO will give you the same results.

Again, it's very easy for me to say this because I don't have to grapple with these difficult problems, but it is very, very important for Congress and the Administration to come to some kind of program, some kind of plan that will credibly show how the United States Government is going to bring itself back to a sustainable position.

Mr. ROYCE. And this plan is not it, I take it?

Mr. BERNANKE. Assuming that those numbers are appropriate, I mean the forecasts are very difficult to make, but assuming they're appropriate, no, it's not.

Mr. ROYCE. The CBO numbers, as you've said earlier, it just is not going to pencil out.

Mr. BERNANKE. That's right, and so it's a very difficult challenge, but it's not something that's 10 years away because it affects the markets today and the longer you wait, the harder it's going to be to change—

Mr. ROYCE. Can you take the message on the road?

The CHAIRMAN. We don't have time for another question. We have votes. I think we can get two more in, and I now recognize the gentleman from California for 5 minutes, and then there will be one other, and then we can go vote. The members who want to vote obviously can go vote now.

The gentleman from California.

Mr. SHERMAN. The gentleman from California, Mr. McCarthy, talks about trade agreements and I would agree with him that if we had genuine free trade that might produce jobs, but so far our trade agreements have given us malignantly-unbalanced trade and I don't think that helps our job situation.

Chairman Bernanke, I'm going to lay out a few reasons that have been put forward why you might want an easier monetary policy, both short-term and long-term, and get your response.

The first of these is that monetary easing short term can help stimulate the economy at zero increase to our national debt and in fact reduces our debt because it reduces our borrowing costs whereas we in Congress are considering fiscal stimulus which, of course, does increase the national debt.

The second is that there is a stickiness in cutting certain nominal payments, particularly wages, and so if we had a modest 3, 4, even 5 percent inflation rate, that in effect solves that problem or allows for the solution of that problem without cutting a nominal amount.

The third is that your predecessor used to come to Congress and say that the CPI was overstating the inflation rate. So if you're targeting for 2 percent inflation rate as measured by the CPI, you were really targeting for a 1 percent inflation rate, as he thought it ought to be calculated.

And then, finally, you have the recent IMF economist report saying that central bankers ought to aim for a higher inflation rate so that in bad times they had more monetary tools. When you start with low interest rate and low inflation and then you try to stimulate the economy, you can't go below zero.

So the first question is, are you currently pedal to the metal? I see the statements coming out that talk about increasing the discount rate and those very statements can have a slight effect, more than a slight effect of reducing monetary easing, taking your—the accelerators—I realize a lot of talk about accelerators in the other room here, but easing up on the accelerator a bit and then your discussion here of the clear statement you're not going to monetize the debt also is a little less than absolute pedal to the metal.

So short term, are you or should you be pedal to the metal? Longer term, should we be aiming for a somewhat higher inflation rate, given the report of the IMF?

Mr. BERNANKE. Well, we were clear that the higher discount rate was not intended to tighten monetary policy and, in fact, if you look at the market, there is no expectation. It did not engender any expected increase in monetary tightness. So that was successful in that regard.

We do have a very stimulative monetary policy, as you know. We will continue to evaluate that. It's a committee decision. Certainly, if the recovery begins to falter, we'll have to look at that very seriously.

With respect to the inflation rate, I understand the argument and it's not without its appeal, but it carries certain risks obviously. If the Federal Reserve says we're going to raise inflation to 4 percent, how do we know that later it won't go to 5 or 6 or 7 percent?

Mr. SHERMAN. Well—

Mr. BERNANKE. It took a long time to get inflation down to 2 percent.

Mr. SHERMAN. Mr. Chairman, I'm going to try to squeeze in one more question. Obviously, if you say two, that's a slippery step toward four. If you say four, that's a slippery slope toward six.

The second is the role of the credit unions. We're in a circumstance where we have taken taxpayer money and injected it into the capital of the banks, but as a matter of the Federal Government, we have prohibited—the Federal Government has prohibited credit unions from raising alternative capital in the private market, not taxpayer money.

We are begging the banks to make loans, particularly under $250,000. The credit unions are beginning for the right to make loans of under $250,000 and not count it against their limit on business lending. They're telling me that they could make another $10 billion in small business loans, create 100,000 jobs, at no cost to the Federal Treasury at all, and with high capital standards and

even higher capital standards if we let them raise alternative capital.

Should we be relying more on credit unions, giving them these tools to get us out of this recession, not that this one thing would get us out?

Mr. BERNANKE. Well, as you know, credit unions are tax-favored because they have certain restrictions on their activities and the banks would complain obviously that if they're allowed to do everything banks can do, why are they tax-favored? So I think that's the trade-off that Congress has to —

The CHAIRMAN. The gentleman's time has expired. There's only time for the witness. If members are going to ask complicated questions with 10 or 15 seconds, don't expect a lot of back and forth.

Does the witness wish to complete his answer?

Mr. BERNANKE. No.

The CHAIRMAN. It's not a mandate.

Mr. BERNANKE. This is the issue about the tax treatment of credit unions.

The CHAIRMAN. The gentleman from Illinois, Mr. Manzullo, will be our last witness. We will break. We will come back very promptly. The Chairman has agreed to stay till 2 o'clock. We can get some more questions in.

The gentleman from Illinois.

Mr. MANZULLO. Thank you, Mr. Chairman. Chairman Bernanke, the district I represent has somewhere between 1,500 and 2,000 factories, it's highly industrialized, and the Institute for Supply Management is up now, above 50, for the 6th month, 7th month in a row.

As I talk to my manufacturers, it's the same choke point. I talk to the regulators. They say that the regulatory standards have not been tightened. I talk to the banks. The banks say they can't lend because of the regulators.

If we want to create jobs, as stated in NAM's new study with the Milken Institute, John Ingram, the president of NAM, said, "The new report makes a powerful case that manufacturing can lead the U.S. into a renewed era of growth. It's critical that we accelerate our economic recovery and create jobs for the benefit of manufacturers."

I have manufacturers that are ready, willing, and able to hire employees. They have orders, substantial orders. They can't get capital in order to make their new product, and in some cases, the buyers are going overseas to buy the product.

We have a choke point in credit. It's a super, super, super crisis. These are existing borrowers. They are people with very, very low debt to equity ratio. They are prime borrowers, many in the food processing industry, which has seen an uptick in this economy, begging for credit, and they come to me and ask, why has the government created more and more programs out there when all we need is a simple operating loan or equipment loan as we had before?

What is the answer? What can I tell them, besides we have been invited to come out to our district and talk to them personally and individually and perhaps help the banks out?

Mr. BERNANKE. Well, part of the issue here is, of course, there is more than one regulator and next time, please ask who the regulator is. If it's the Federal Reserve, I would like to hear from you and I'll be happy to talk to you about it.

We at the Federal Reserve understand that, and we should all understand, we don't want banks to make bad loans. If a borrower is not financially able to manage the loan, we don't want to make that loan, but you're talking about situations where you say the borrower is creditworthy. In that situation, we want the bank to make the loan.

I have answered a number of questions about steps we have taken to gather more information, to have meetings and to train our examiners to focus on this exact point. So we are very, very focused on trying to keep that in balance.

Mr. MANZULLO. I know you are, Mr. Chairman. The problem is that it's simply not getting through and it's not your fault, and I don't think it's the fault of the regulators there either because everybody is skittish because of the economy, but the problem is we're at the beginning of a real recovery, not make-up jobs for the dumb Stimulus Bill, not creating government jobs, but the creation of real jobs of people in manufacturing going back to work and exporting and many of these are highly-paid union jobs. They just can't get the money and they're creditworthy.

It doesn't make sense for us to have all this debt, all these programs, people ready to go, they're creditworthy, but they can't get the money in order to make the product to create the jobs.

Mr. BERNANKE. I would be happy to hear more details and try to figure out what's going on because we are working very hard to make sure that's not the case in banks that we supervise.

Mr. MANZULLO. Is it possible, Mr. Chairman, that you could meet personally with some of these people?

Mr. BERNANKE. Certainly.

Mr. MANZULLO. I'll take you up on that. Thank you, sir.

The CHAIRMAN. The committee will be in recess. I intend to come back as soon as I can. It's the third vote. It shouldn't be too long. Any member who wants to ask questions, if they're here, we'll call on them.

[recess]

The CHAIRMAN. The committee will reconvene, and the gentleman from New York, Mr. Meeks, will be the next questioner. And the committee will be in order. Someone please shut the door. The gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman. It is good to see you, Chairman Bernanke, and congratulations on your reappointment, and thank you for your service.

My question—and I'm trying to focus more around real estate and the housing industry, I know some of which you deal with and some of which you do not based upon some of the questions, but it is to me—most Americans, it is their largest investment that they will ever make—is in their home.

And in listening to some of your testimony earlier, and I know that by, I guess, March 31st, you are scheduled to end the Fed's program to buy more mortgage-backed securities from Fannie Mae and Freddie Mac-backed debt, and I guess there is pressure to

tighten up. And the last time the tightening took place, I think it was about 33 months ago, after the recession began and foreclosure rates were 4 times lower than they currently are. And there are signs, from what you are saying now, of growth.

But my first question is, is it a little premature to consider tightening today because—will that kill the incipient housing recovery by tightening today and then hurting the housing market?

Mr. BERNANKE. We will still continue to hold $1.25 trillion of mortgage-backed securities, plus additional agency debt, and we think that is going to continue to keep mortgage rates down. There are a lot of differences of view about how much mortgage rates might go up after the end of this program. So far, we haven't seen much, so I think we need to look and see if there is a big reaction, if it does affect the housing market. It may not be a significant reaction, so we are going to continue to watch that.

Mr. MEEKS. We have seen that, for example, also—and I think especially in California, to a degree in New York also, and other places—I have talked quite frankly to some friends of mine.

But in California where they have no recourse laws, we find that where banks are unwilling to write down the principal—and I know you talked about the HOPE program and writing down, but it seems now banks are not willing to write down principal. A lot of it was simply walking away. And then that is causing a difficulty on the banks and especially the small and community banks, and thus we heard about banks that may be closing as a result, especially the smaller community banks.

So I was wondering if there are any steps that the government, the Federal Government, can take or the Fed can take to help banks—or to encourage banks, I should say, to write down principal on homes that are now underwater, which is to me one of the biggest drags on the economy overall also.

Mr. BERNANKE. We found in our research that the combination of being underwater and then having loss of income due to loss of a job and so on—those two things are very high predictors of default. So right now, the main programs for mortgage restructuring are the Treasury's programs under the TARP, the so-called HAMP program, which is an affordability program. My understanding is that they are going to be looking at alternative pilot programs that will take different approaches. And of course we also have the HOPE for Homeowners, which has the principal write-down element.

So I think this is really an area for Congress, but clearly there is a lot of interest in the Administration and Congress to reduce the number of foreclosures, which remains very, very high.

Mr. MEEKS. Yes, because what is happening is a lot of individuals that I know, homeowners in my district who are struggling to pay their mortgage, they are actually paying it, but they are underwater. And then they go back to the banks to have it refinanced and try—but then they are so far underwater, nobody will give them a loan, so now they are nervous and some of them have interest rates that can reset high and they won't be able to afford them.

And then we get back in—just as you talk about moving in the right direction, then we get back into a foreclosure problem where more and more people are going into foreclosure. And I think that

if we could do something earlier on to prevent that, that would be, I think, a smarter way to go.

Mr. BERNANKE. Well last year, in part because of our program of buying MBS and bringing mortgage rates down, there were millions and millions of refinances, which got people into better shape. And I believe that Fannie and Freddie will refinance some people who are underwater if they meet other criteria.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for being here, Chairman Bernanke.

You have heard it several times today, but small businesses can't get credit, and obviously they need it. And I understand you are not the only regulator, but one of the issues which I would appreciate your view on is that the community banks are being asked to reassess commercial real estate loans, devalue then because of FASB's mark-to-market accounting rules, and subsequently can't get the credit. Even though these are performing loans; they are not in any problem.

But the result is that commercial loans are being called in, lines of credit are being cut off, and creditworthy small businesses can't get credit. Do we need to reassess, expand, and—or do something with FASB's accounting rules again? Regulators' implemented implementation doesn't seem to make much sense.

Mr. BERNANKE. Congresswoman, we and the other regulators just recently issued a guidance for banks on commercial real estate which explains how to restructure a loan which is in trouble, makes the point that a loan which is paying, but has a reduced collateral value should not be considered impaired under most circumstances. And it has been well regarded because the guidance provided a number of concrete examples about how to deal with troubled loans. So we have made a very concerted effort, I think a well-regarded effort, to help banks deal with the CRE problems.

Now if the loans are bad, then clearly there is going to have to be some write-down.

Mrs. BIGGERT. This is where the loans are performing. The customer is paying the loan off, but they say "Well, in the next year, it probably won't be good, so you should revalue it now." This has happened in my community. And then on top of having the FDIC coming in with this assessment in December, they can't work with it with the capital that—

Mr. BERNANKE. Again, we are not requiring banks to write down loans just because the collateral value has declined.

Mrs. BIGGERT. Okay. Then you said in response to Mr. Castle's question, there is a memo of things Congress can do for job creation, and my constituents need jobs. Can you give me three examples of the menu that you talked about?

Mr. BERNANKE. Well, I think Members would disagree, but just to give you three examples, you could provide funding for State and local or infrastructure type spending, which would have some job impact. Other Members might prefer tax cuts for corporations to make them more competitive. A third possibility would be to adopt one of these programs to try to encourage small banks to make small business loans, like the one that the Treasury has proposed. So those are three very different types of programs, and I know dif-

ferent Members have different preferences, but there are many different things that you could consider.

Mrs. BIGGERT. Okay. And one of them might be trade agreements?

Mr. BERNANKE. Of course, details matter, but I think in general, open trade creates a lot of opportunities and there certainly are a lot of firms in the United States that rely heavily on exports. And indeed, manufacturing has been leading the recovery so far, and part of that is because they have been able to take advantage of export markets.

Mrs. BIGGERT. Then lastly, when implementing the so-called Volcker Rule that has been recently proposed by the Administration which would seek to limit, or in some cases eliminate, proprietary trading at financial institutions, would this reduce liquidity, would it add to the volatility in the capital markets, or is it a good thing?

Mr. BERNANKE. First of all, we all agree that we don't want banks to take excessive risks when they have a safety net from the government. So the question is, then, how do you control those risks?

The Volcker Rule might be appropriate. You have to be careful that you don't inadvertently prevent good hedging, which actually reduces risks, or that you don't prevent market making, which is good for liquidity. One possibility is that—if you were to go in this direction would be to give some discretion to the supervisors to decide whether a set of activities is so risky or complex that the firm doesn't have the risk management capacity or the managerial capacity to deal with it and then give the supervisors the authority to ban that activity. So there might be ways to do it using supervisors.

The CHAIRMAN. The gentlewoman's time has expired.

Mrs. BIGGERT. Thank you.

The CHAIRMAN. I recognize the gentleman from Kansas and ask for 10 seconds to say that the amendment to the House bill embodies precisely the approach that the Chairman just recommended with regard to proprietary trading, and it is in our bill.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

And Mr. Chairman, the economist Mark Zandi testified yesterday that policy uncertainty is playing a role in the business community's lack of confidence.

It will be 2 years next month since the financial crisis started in full with the failure of Bear Stearns, and Republicans and Democrats have been in agreement of the key principles of financial reg reform, including increased consumer and investor protections, strong oversight of derivatives and executive compensation, new dissolution of authority to safely unwind the next AIG while protecting tax payers, stricter capital and leverage standards, and a financial reg structure that monitors systemic risk. The House recently passed a strong bill that accomplished all of these principles, in my judgment, that the Senate is now considering. And we need to eventually reform housing finance after considering the best ideas and the ways to do that.

Mr. Chairman, will uncertainty increase or decrease in the business community if Congress delays these important reforms, or should Congress enact these reforms into law this year, now, so businesses know what the rules of the road will be? Won't that encourage investment and hiring in your judgment?

Mr. BERNANKE. Clearly, Congress has to take the time it needs to deliberate, but I agree with your basic premise that if there is excessive delay, it will create uncertainty about what the regulations are going to be, how much capital will be required, and so on, and that makes banks more reluctant to lend, for example.

Mr. MOORE OF KANSAS. Thank you, and one last thing. My colleague from Illinois, Mrs. Biggert, just asked you a question about commercial real estate, and I want just a little different, I think, than her question. I am concerned about the commercial real estate market—I think all of us are—and what impact that is going to have on the economic recovery.

The Congressional Oversight Panel for TARP issued a report this month expressing concern that a wave of commercial real estate loan losses over the next 4 years could jeopardize the stability of many banks, especially community banks, which I think really are not responsible for what we have seen in this whole situation. In the report, they say, "A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American."

Mr. Chairman, I heard your response to Mrs. Biggert. Is there anything else that you can suggest or that Congress should look at to minimize the negative impacts of the commercial real estate crisis?

Mr. BERNANKE. I think one thing that would help would be just the general improvement in the economy, and that is one reason why the Federal Reserve has been using accommodative policies. And some of the ideas you have just raised about reducing uncertainty and trying to stimulate growth, those are the kinds of things that would lead back to having people go to the mall or having people be employed and housed in an office building. So that is one, obviously, direct way. I don't have another good suggestion for you, but I would be happy to talk to you about it.

Mr. MOORE OF KANSAS. Thank you so much, Mr. Chairman. I yield back my time.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you.

Chairman Bernanke, I want to follow up on a question that one of my colleagues had that I am not sure I heard a precise answer to. I think the question was a variant of, what is the level of desirable or necessary leverage within the banking system on a macroeconomic level to hopefully ensure we don't repeat what we have just been through?

Clearly, there are those within Congress who believe in artificial limits to the size of financial institutions, who believe that Federal regulators should have power to prohibit certain credit offerings. But some of us believe that hopefully out there is a proper application of risk-based application of capital and liquidity standards that would hopefully, perhaps, lead to a more prudent leveraging within our economy.

But the question is, from your perspective, on a macroeconomic level, what is the amount of leverage the system can handle a cyclical downturn?

Mr. BERNANKE. That is not an easy question to answer.

Mr. HENSARLING. That is why I asked you.

Mr. BERNANKE. It is not a single number, because as you mentioned in your question, first of all, it is risk-weighted. It depends on the mix of assets. As you know, we currently have the 8 percent requirement under Basel II. I think we want to, first of all, increase the risk weights so that there is more protection against risky assets, number one. Second, we want to make sure the capital is of higher quality that is more common equity and less subordinated debt instruments, for example. And third—

Mr. HENSARLING. Mr. Chairman, if I could. I understand that, but does the question defy an answer? Is it possible to quantify on a macroeconomic basis?

Mr. BERNANKE. I'm sorry. It is certainly possible, but we are currently engaged in a very elaborate process with the Basel committee and other colleagues around the world to try and determine that number. We don't have a single number yet that we can give you.

Mr. HENSARLING. And Mr. Chairman, when might we expect that number from on high?

Mr. BERNANKE. The objective is to have it by the end of this year.

Mr. HENSARLING. Thank you. Mr. Chairman, you answered several questions. Clearly, you believe, as do many others, that the Nation is on an unsustainable fiscal path, and I think you have described quite eloquently, as have other prominent economists, the dire consequences associated with that.

I don't think I quite have the lyrics right, but I'm reminded of a country and western song that says something along the lines of, everybody wants to go to heaven, they just don't want to go now. So we have so many people who claim they want to do something about this problem, but with one exception offered by Congressman Ryan of Wisconsin, I haven't seen any plans put on the table.

Taking default off the table, because it is totally unacceptable, assuming for the moment we do not achieve any level of spending discipline we haven't been able to achieve in previous decades, I'm under the impression we cannot grow our way out. I don't have the number at my fingertips. I think I have seen at least some studies suggesting we would have to have double digit economic growth for the next 3 decades to grow our way out. Can we grow our way out of this problem?

Mr. BERNANKE. I don't think so, not in the medium term.

Mr. HENSARLING. Okay. If we can't grow our way out, you have said repeatedly you do not intend to monetize the debt, although there are a number of people within our economy who think you are already doing that. We will leave that subject to a different time and place.

That unfortunately leaves, under my hypothetical, tax increases. I have seen studies that show that if we only try to solve this problem on the tax side, that number one, just over the next 10 years of the President's budget window, we would have to increase in-

come taxes roughly 60 percent. Have you seen similar studies? Has the Fed researched this?

Mr. BERNANKE. That sounds like the right order of magnitude.

Mr. HENSARLING. Okay, and my children, who are young, according to a CBO analysis, we would see tax brackets go—10 would have to go to the 25 percent bracket, 25 to 63, 35 percent bracket to 88. It is fairly dire. So have you modeled what would happen to the economy if we indeed had tax increases of this magnitude?

Mr. BERNANKE. I don't know the exact numbers, as I said, and obviously forecasting is difficult, so I don't want to put too much weight on any single number. But I think you and I would agree, I think most people would agree, that a big increase in marginal tax rates is going to be counterproductive from a growth perspective.

Mr. HENSARLING. I hope I can slip this in, in the seconds I have left. Recently Alan Meltzer wrote an op-ed in the Wall Street Journal, and my guess is that you are familiar with it, that asked the question how much one might have to pay on the interest on the bank reserves. I'm not sure you have—I haven't seen you answer that question publicly and I want to give you that opportunity.

Mr. BERNANKE. We think—

The CHAIRMAN. We are into the deficit now, so if you can give a brief answer, otherwise it will have to be in writing.

Mr. BERNANKE. We think that the interest rate we pay on reserves will bring along with it the Federal funds rate within tens of basis points. Not a tremendous difference.

Mr. HENSARLING. Thank you, Mr. Chairman.

The CHAIRMAN. You can elaborate in writing.

The gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. Chairman Bernanke, welcome, and thank you for coming to visit with us and give us an update.

I represent the 15th Congressional District of Texas, and I refer to it as deep south Texas. We are along the Texas-Mexico border, and our county is about 750,000 people and it has the highest concentration of—about 89 percent Hispanics. Hidalgo County is one of the poorest.

I'm going to preface my question by saying our area was plagued by a double digit unemployment for about 35 years before I came to Congress. And to give you an idea, in December of 1990, the unemployment rate was much higher than Detroit, Michigan, is today. It was 29 percent. In January of 1996, when I came to Congress, it was 24 percent. The unemployment rate dropped over the 14 years that I have been in Congress. In April 2008, it was 6 percent. So even though we have seen an improvement, and today even though it is 11 percent, it is very close to the national average.

So what do we do to try to bring it back down to 6 percent when the banks tell me—the community banks and the large banks say that they are lending money, but there is no proof that there is because so many businesses have closed, so many signs for rent, buildings that are now empty and spaces that are empty? Then we get the credit banks representatives coming to visit me and say that they want us to support their mission statement to expand it

so that they can lend money to small and medium-sized businesses. And I'm torn between supporting that idea.

I heard the President say just recently that there was going to be $20 billion from the TARP money being repaid to us in Federal Government available to make money available to the small and medium businesses. Tell me, what is the answer for regions like mine, very poor, very large, and that we can't seem to have access to capital?

Mr. BERNANKE. I know you are asking the questions, but I would like to hear some time how you got the unemployment rate down the way you described it.

Again, I think if I'm not mistaken, the Treasury is proposing to provide capital to CDFIs, Community Development Financial Institutions, which are banks or other institutions, which make more than 60 percent of their loans to low- and moderate-income communities. I think that is a very constructive thing to do. So that is the kind of vehicle that could bring capital into a lower-income community using TARP money, essentially.

Mr. HINOJOSA. Would you support the idea that our chairman of the Small Business Committee, Nydia Velazquez, has proposed, and that is that there be more direct loans instead of being bank loans through the Small Business Administration?

Mr. BERNANKE. I think that is really up for Congress to decide. I think you need to investigate. Her view, she said earlier today, was that going through the banks would not work because they wouldn't take the TARP money. Whether that is true or not, I don't know. So I'm sorry, I don't have a recommendation, and I think Congress is going to have to look at those two options.

Mr. HINOJOSA. One of the sectors that helped us bring the unemployment down was the housing, the construction of both retail businesses and residential. What is your projection for things to turn around for that sector so that they can help us bring that unemployment back down to the 6 percent that I have a goal to do?

Mr. BERNANKE. Unfortunately, the construction was probably overinflated for a period, and now it is quite weak. I wouldn't conjecture to see a big return of construction, either of residential or commercial, for some time. We still have a lot of unsold homes, for example, a lot of high vacancy rates, and also high vacancy rates in commercial real estate, so there is not, at this point, a lot of demand for new construction.

Mr. HINOJOSA. My last question—

The CHAIRMAN. No, your time has expired, I'm sorry.

Mr. HINOJOSA. Thank you Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MCHENRY. That is on how that affects—

Mr. BERNANKE. The different mechanisms to the extent that the fiscal thrust is expansionary, it creates some additional growth that would potentially affect Federal Reserve policy, except we are at the zero bounds, so we are not responding too much there.

One risk that I have described is that if there is a long-term loss of confidence in the long-term capacity of the government to balance its affairs, that could raise interest rates today, which would have a drag effect on the economy.

Another possibility, which I think is relatively unlikely, but is certainly possible, is that if there is a loss of confidence again in the government's ability to achieve fiscal stability, that the dollar could decline, which would have potentially inflationary impact on the economy.

There are a number of different channels through which large deficits or unsustainable deficits could affect the current economy.

Mr. MCHENRY. I have heard various economists say that a deficit of 3 percent of GDP over the long time is sustainable and anything beyond that is unsustainable. Is that fairly accurate?

Mr. BERNANKE. That is roughly right. The idea here is if you have a growing economy, you can run deficits and still maintain a flat ratio of debt to GDP, which is a sustainable situation.

Normally, that would involve having what is called a primary deficit, that is deficit excluding interest payments from about zero. Normally, that would involve about 2.5 percent to 3 percent of a total deficit, including interest payments.

Mr. MCHENRY. Beyond that, it could have a destabilizing effect on the dollar and obviously interest rates on top of that?

Mr. BERNANKE. If protracted. I mean for one year, it does not necessarily have a big impact. If it looks to be going on indefinitely, certainly.

Mr. MCHENRY. In terms of liquidity in the system right now, are we still facing deflationary pressures? Is that a part of your consideration in the months ahead?

Mr. BERNANKE. Right now, we do not see deflation as an imminent risk, and neither do the financial markets, which seem to have inflation expectations of around 2 percent or a little higher. There are scenarios in which they would become more of a concern. Right now, we do not see that as an imminent risk.

Mr. MCHENRY. In terms of tax rates and financial regulatory policies and those larger issues, could we see a scenario where between high corporate and personal income taxes that we have an outflow of capital to lower tax regimes around the world, is this a concern for our long-term growth, price stability, and full employment?

Mr. BERNANKE. Certainly. In some sense, the cost of large deficits is that tax rates in the future are likely to be somewhat higher. As I was talking to Mr. Hensarling, that can be bad for growth in lots of different ways.

One possibility is that it makes the country uncompetitive, relative to other countries in terms of their tax costs of production, although there are exchange rates and other factors that would affect that.

Clearly, very high tax rates tend to make a country less productive.

Mr. MCHENRY. Over a 25- to 50-year horizon, you said over the medium term, we cannot grow our way out of this structural budget deficit, to Mr. Hensarling's point, over the long term, is that going to be possible or is it going to require a period of spending?

Mr. BERNANKE. Nobody really knows for sure, I want to emphasize. We are an aging society. The fraction of the population that is working is going to be going down for a long time, and at the

same time, the number of people who are going to be requiring Medicare and other types of assistance is going to be rising.

Barring very sharp changes in our growth rate in productivity, I do not think that would be very likely; no.

Mr. MCHENRY. Thank you.

The CHAIRMAN. The gentleman from Texas. Let me say we will be able to accommodate all the members here now. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. I thank Chairman Bernanke for appearing and congratulations again on your being reappointed.

Chairman Bernanke, I would like to make a comment, and I may want you to say a word, but I am not sure that I do until I finish. Sometimes, I have to wait until I finish to know what I am going to say.

When we talk about the TARP, we sometimes confuse it with let's just use the terms that the public can relate to, the bank bailout, we sometimes confuse it with a stimulus. The bank bailout was an initiative proposed under the Bush Administration. My belief is that the President himself supported this initiative and in fact made public comments in support of it.

When it was finally passed, because it did not pass on the first vote, but when it passed on its second vote, it was a bipartisan passage. It was supported by 91 Republicans.

I think sometimes this is lost in the translation, that 91 Republicans supported it. As a matter of fact, we had about 10 Republicans, friends of mine, and this is not to demean them, I just want to get the facts straight, 10 friends of mine who sit on this very committee supported it. This is not in any way demeaning, just to have it as a statement of fact.

What I would like to do, Mr. Chairman, with your consent and permission and without any objection, is submit the final vote results, the roll call vote, if you will, on this piece of legislation. May I submit this for the record?

The CHAIRMAN. So ordered, without objection.

Mr. GREEN. Thank you very much. A simple "yes" or "no" will suffice. Is what I stated correct saving the vote count, I do not expect you to know this, but the fact that it was a bipartisan effort and the TARP is separate and apart from what we call the "stimulus?"

Mr. BERNANKE. Yes.

Mr. GREEN. Thank you. With reference to trade, I think we do ourselves a disservice when we discredit legitimate positions that are made by what we call "the other side." I think there is some good in trade.

In fact, I believe we ought to have trade. "Free trade" is a term of art. "Fair trade" is a term of art. The question becomes for some how will the trade impact not only the exports from our country but also imports in that sometimes jobs will occur in countries wherein you can get workers for pennies a day, whereas in this country, it is going to cost you dollars per day to get a worker, and there seems to be the notion that this can influence where the businesses will locate jobs and hence, by locating them in places where

they have pennies per day, they are in fact in a sense taking the jobs from this country, from the United States.

That is the concern. I think we have to try to find a balance that accommodates everyone when it comes to this concern. I respect the fact that we can import and export and these exports will create jobs here in this country.

Is this a fair statement to say there is a balance we have to try to strike?

Mr. BERNANKE. The point that you are making, which is correct, is that trade does not necessarily benefit everybody. It might make some people better off, and in particular, people with low skills who are competing implicitly with low-skilled workers around the world might be made worse off.

Some people have attributed some part, perhaps not a large part, but some part of increased inequality to increasing trade. That is a concern.

I think most economists would say the right solution is not to block trade because trade creates a lot of wealth, but rather to find other ways to help low-income people, low-skilled people acquire skills or otherwise make themselves better off.

Mr. GREEN. Would you agree that one of the things that we might do is try to help those countries where they have people working for pennies per day that may not have labor standards that people of goodwill would agree with? We might also try to influence what they do if we trade with them.

It would not cause me as a person, a human being, to feel good about an effort that would cause persons to work for pennies a day and allow me to benefit when they are working under conditions that are less than tolerable by my standards.

Mr. BERNANKE. It is a very hard question. Certainly, you want to have humane conditions. Low income is a fact of life in poor countries and sometimes trade is an opportunity to better yourself.

Mr. GREEN. I agree. We have a balancing test with this as well. I see that my time is up. I did not get to the real question I had for you, but I will get to you next time. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Minnesota, and as he begins, I would ask the gentleman from Idaho to come and assume the Chair so I can go talk about fishing and we will be able to take the last three members.

I thank the Chairman for his indulgence and I also want to thank the members. I think it has been a thoughtful and civil hearing, which I appreciate being able to do.

Mr. PAULSEN. Thank you, Mr. Chairman. Chairman Bernanke, we have had a lot of discussion earlier and I was gone for part of it, I know we discussed mostly about the deficit, the national debt and the effect of long-term borrowing in terms of the Federal Reserve's policies.

Let me ask this, some have made claims that taking steps to put our fiscal house in order, to right ourselves right now, could itself be stimulative in some effect.

What impact would implementing policies that are more focused on the long term have on the short-term dynamic, if we just thought more about the long term going forward thinking as op-

posed to dealing with the short-term challenges that we do face right now with our economy?

Mr. BERNANKE. It is possible that a persuasive, creditable long-term plan for fiscal balance would be stimulative today by lowering interest rates and perhaps increasing investment because people would not be worried about high taxes, for example.

It is certainly possible a good plan would actually pay off in the present, not just in the future.

Mr. PAULSEN. Let me ask you this, does the large budget deficit right now, does it really impair the Fed's ability to either stabilize prices or ensure long-term growth?

Mr. BERNANKE. No, I do not think so. I think we do have to recognize, I want to be clear, given the depth of the recession, the fact that revenues have fallen from the normal 19 percent of GDP to 15 percent, given the payments to the unemployed and so on that are obviously important during a deep recession, it is not surprising that we have a deficit this year. I do not think any reasonable policy could eliminate that deficit this year.

The answer to your question is no, I do not think so, but clearly, a long-term unsustainable policy would have bad consequences.

Mr. PAULSEN. How does the large Federal balance sheet that you opened up a little bit with your testimony and talked about a little earlier impede your ability to set interest rates?

Mr. BERNANKE. Are you talking about the Federal Reserve's balance sheet?

Mr. PAULSEN. Correct.

Mr. BERNANKE. If we had no other tools, it would create a problem because with so many reserves in the system, such a large supply of reserves, you would not be able to raise the Federal funds rate, which is the price of reserves.

However, as I described in my testimony, we have a number of tools, including interest on reserves and various ways of draining reserves that will allow us to raise interest rates at the appropriate time, notwithstanding the fact that we have the large balance sheet.

Mr. PAULSEN. How long do you think it will be before the Federal funds rate becomes the benchmark again for overnight lending, and how tested are these tools that you have to employ or you plan on employing in the near future, I guess?

Mr. BERNANKE. None of them have been completely tested. We have not been in this situation before. On the other hand, we have a belts-and-suspenders kind of situation here. We think the interest rate on reserves by itself could be used to tighten policy and there are good economic reasons to think so. Beyond that, we have these additional tools that would allow us to drain reserves, just to make doubly sure.

In fact, beyond that, although we do not anticipate selling any of the assets on our balance sheet in the near term, if we absolutely had to, that would be another way to reduce the size of the balance sheet.

Mr. PAULSEN. Okay. Thank you, Mr. Chairman.

Mr. MINNICK. [presiding] The Chair recognizes the gentleman from North Carolina for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. My questions are also about how to encourage lending. I am sure as a scholar of the Great Depression, you know the Reconstruction Finance Corporation did not start out with a direct lending program.

They only resorted to that when they could not persuade banks to lend, when they tried to lend to banks for the banks to lend in turn, that did not work. They tried to buy preferred stock in banks so banks could have additional capital. That did not work.

It was only then that the Reconstruction Finance Corporation began direct lending, and 20 years later, when the program was ratcheted down, it had turned a slight profit. It does appear it is possible to lend even in a bad economy with proper underwriting.

I am sure I am in a distinct minority in this committee in thinking that it was probably a mistake to—we were probably better off having mark-to-market rules for accounting, that it is better to know what is on a bank's books, to have an accurate idea of the assets and of the liabilities.

I was also skeptical a year ago about the stress test, that would be seen as a rigorous test, a real measure of the sovereignty of banks. I have been surprised at the amount of capital that has gone into those 19 banks.

A couple of questions. To what extent was that the result of investors getting confidence to cause the stress test, because they did feel reassured their books were accurate, and to what extent was that because investors became convinced that the government was not going to allow any of those 19 institutions to fail, that they were too-big-to-fail?

Second, with respect to community and regional banks, it does not appear that capital is flowing into community and regional banks in the same way they flowed into those 19 bigger banks.

Do you agree it is important they have additional capital? Are they trying to acquire it? Is that because of the skepticism about what is really on their books? Do they have accurate books or are their books being cooked somewhat?

To what extent because they are too small to fail and investors know they may in fact lose their entire investment in a way they cannot possibly lose their entire investment at the bigger banks?

Mr. BERNANKE. It is my belief, first of all, on the stress test, I think that the revelation of information, the fact that the government showed what the underlying evaluations were and what the potential credit risks were, that cleared up a lot of the uncertainty in the market and that is why so much capital flowed in.

I think the alternative that it was a "too-big-to-fail" issue would not work because there was not really a change in that respect, and in any case, when a "too-big-to-fail" institution comes under stress, the shareholders can definitely lose money, as they did in many of these big banks.

I do think the stress test was quite successful in that respect in providing this information to the markets.

I think it is hard to distinguish two explanations for why the regional banks have raised less, some of them have raised some capital. Part of the problem is they are in fact—regional banks and smaller banks—more exposed to commercial real estate, which right now is the more stressful area, so therefore, it is not a ques-

tion of information, but a question of the fact that some of those banks are facing that highly stressed situation.

Surely, we are advising and supporting capital raises, particularly of common equity, by banks of all sizes, and some of the 19 banks were in fact big regionals, and some of them have been able to raise capital and pay back.

Mr. MILLER OF NORTH CAROLINA. Is there a confidence among investors that the books of the regional and community banks are accurate, that their assets are properly valued?

Mr. BERNANKE. I have not heard anything to the contrary. I guess you would have to ask the investors.

To respond to your earlier point, I think mark-to-market can be very useful in terms of information, but I think for banks, which have long-term loans on their books, often it is very difficult, because there is no liquid market, it is very difficult to get an accurate price of what a long-term loan might be worth, and even a large commercial real estate loan might be very hard to price accurately.

For capital and regulatory purposes, I think you do need to look at the hold to maturity prices as well as the mark-to-market prices.

Mr. MILLER OF NORTH CAROLINA. I will yield back the little bit of time I have left.

Mr. MINNICK. The gentleman from New Jersey, Mr. Lance, for 5 minutes.

Mr. LANCE. Thank you very much, Mr. Chairman. Good afternoon to you, Chairman Bernanke.

Was the Federal Reserve consulted before the Administration announced its proposal about $100 billion in taxes on banks across the country?

Mr. BERNANKE. I think there were some technical discussions. You are talking about the financial responsibility fee?

Mr. LANCE. Yes. What are your views, Mr. Chairman, on the imposition of that amount of money on banks across America?

Mr. BERNANKE. I think in terms of whether or not to impose a tax on the banks, that is obviously a fiscal matter, and Congress has to decide about that. I do think it is important that it be imposed in a way that it does not have unintended consequences.

One issue which has arisen is that imposing the tax on non-deposit liabilities could have some negative consequences for the repo market, as an example.

If you want to impose the tax and many do, you just want to be sure to do it in a way that does not create unintended consequences.

Mr. LANCE. My point of view is that the tax should not be imposed because the banks by and large have paid back their TARP funds with interest, and those that are still outstanding, General Motors and AIG, would not be liable, as I understand it.

I have a concern that it would lead to even less lending than is now the case. Does the Federal Reserve Board have a position on that aspect of what might occur as a result of imposition of these taxes?

Mr. BERNANKE. You are correct that the large banks have paid back the TARP, and in fact, I think it is important to say that the financial part of the TARP, even including AIG, is not that far in

the red at this point. I think there is a very good chance the taxpayers are going to come out whole in this entire process, which is an important thing to recognize.

Mr. LANCE. Yes. The rhetoric of the President when announcing this was in direct relationship to the fact that funds were used for TARP and they are being paid back. I just have the greatest concerns that this would mean less lending than would otherwise be the case.

Mr. BERNANKE. I believe one reason for the proposal is the law requires that the President make a proposal on how to recoup the TARP money, and the TARP technically does include not only the auto losses, but the mortgage modification program as well.

Mr. LANCE. Thank you, Mr. Chairman. Another area you note in your testimony, that more than half of the fourth quarter GDP growth was due to restocking of inventories. I do not think that can continue without demand for goods of those inventories.

In my opening remarks, I talked about consumer confidence and the report others have cited. Today's figures with a lack of consumer confidence, what do you believe might be the most effective way the Federal Reserve moving forward could instill even greater consumer confidence in such a large percentage of our economy?

Mr. BERNANKE. I think the confidence issues, particularly the number we saw yesterday, are tied pretty strongly to the labor market situation.

Mr. LANCE. Yes.

Mr. BERNANKE. All the things we have talked about from the monetary policy side, lending, from whatever actions Congress wants to take on the employment side, I think those are the issues that will create stabilization in the labor market, and that in turn is one of the keys to consumer confidence.

Mr. LANCE. I thank you. A statement, not a question, Mr. Chairman. I think consumer confidence is at the heart of restoring the economy, getting more people working in America since it is such a large percentage of the overall economy, and I am deeply concerned about any bank tax as suggested by the President's proposal because I think it would lead to less lending by banks and what we need in this country is more lending, not less.

Thank you. I yield back the balance of my time.

Mr. MINNICK. The Chair recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you. In this week's Economists magazine, there was an interesting article on Canada and the situation they are in, where they are seeing an incipient housing bubble reemerge.

They have kept interest rates very low for the same reasons we are doing, to try to restart industrial and business spending, and because if this persists for a long time, some of that money is going to leak out and could make a housing bubble.

China is also facing similar problems where they have responded, as has Canada, by actually increasing the amount of money you have to put down on a real estate investment, an investment, as opposed to one you live in.

I was wondering do you have contingency planning? Are there tools available that you are thinking of in case you keep interest

rates low for an extended period of time, and all of a sudden, in regions of the United States, this starts to show up as a local or national real estate bubble?

Mr. BERNANKE. We are monitoring that very carefully. It is obviously very difficult to know if there is a bubble, particularly in the early stages. Our best assessment right now is there is not any obvious level in U.S. economy. If there was a bubble, then the response probably would depend on which asset it was, what part of the economy it was.

My view is that in the longer term, when possible, you want to address those kinds of systemic risks through regulation and supervision rather than through monetary policy, but if there were not appropriate tools, and you are right, there are some countries where they can vary the loan to value ratio as a policy tool, which I think—

Mr. FOSTER. It is a very valuable handle that we have not used in this country yet and maybe we should look abroad and think about using that.

Mr. BERNANKE. Given that we do not have that tool, we would have to see what tools we did have.

Mr. FOSTER. Do you feel that you do not have that tool? You have had the ability to set nationwide mortgage origination standards since the early 1990's, is my understanding. The question is if you just said okay, everyone, 5 percent down, 8 percent down.

Mr. BERNANKE. Our standards are based on a finding of unfair and deceptive practices.

Mr. FOSTER. You feel you need additional authority, legislative authority?

Mr. BERNANKE. I think so, particularly if you wanted to make a rapid change, because these processes take a long time, rulemakings and so on.

Mr. FOSTER. As you know, I am an enthusiast for actually looking into this as a way of stabilizing our economy against future, especially real estate, bubbles.

We had some testimony from our snow-canceled hearing by a gentleman called Richard Koo from Nomura Securities Institute, and he talked about what he called a "balance sheet recession."

He said there was a qualitative difference between normal business circumstances where businesses respond to a lower interest rate by actually expanding operations, and a situation where after the bursting of a bubble that was fueled by deficits and so on, that you behave differently.

If you are terrified you are insolvent, then a lower interest rate does not interest you, except in helping you pay off your debt faster.

I was wondering if you think that is a valid point of view and really if there is an element to that.

He made the comparison also of Japan 15 years ago and the United States today. I was wondering if you would comment on that.

Mr. BERNANKE. I think there is some validity. I think that is an interesting perspective. In fact, my own research when I was an academic addressed some of those issues as well.

It does not mean that monetary policy, for example, is impotent because, for example, lower interest rates can improve balance sheets by lowering interest costs or raising asset values. It is a different mechanism through which monetary policy has its effects and through which the business cycle operates.

Mr. FOSTER. Finally, if you are paying interest rates on reserves, does that have a big effect on the profitability of the Fed? In case no one else has thanked you, I want to thank you for the $50 billion and some you returned to the Treasury. Maybe what we need actually are more Federal reserves, and not fewer, if we could replicate you.

Mr. BERNANKE. It would reduce the profitability a little bit because we would have a higher cost of funds, but since we are making 4 percent-plus on the MBS, we still have quite a bit of margin there. It would still be a positive cash flow.

Mr. FOSTER. Thank you very much. I yield back.

Mr. MINNICK. The Chair recognizes the gentlewoman from Minnesota for 5 minutes.

Mrs. BACHMANN. Thank you. I appreciate that, Mr. Chairman, and thank you so much also for coming, Mr. Chairman.

One thing that constituents have continued to ask me about is if we are any closer to an audit of the Federal Reserve and knowing what the overnight loans are, the collateral requirements, who is getting the loans, and are we any closer. I get that question asked almost everywhere I go, where are we at in terms of auditing the Fed.

Mr. Paul had a bill— where are we at with that, and what is the response of the Federal Reserve?

Mr. BERNANKE. In my testimony today, in my written testimony, I made a proposal that we would be glad to support complete audits of all the emergency facilities and all aspects of those facilities with disclosures of the names of the borrowers with an appropriate delay. All of that, we are very supportive of.

Our concern with Mr. Paul's bill and similar bills is that the word "audit" is not just a financial term, it is also a policy evaluation term. As written, his bill will allow the Congress to ask the GAO to come in and essentially determine whether they thought the Federal Reserve had made a mistake in its interest rate policy or not.

We think that would be inconsistent with the very important principle that Congress should not be managing monetary policy, that the Federal Reserve should be independent in making its monetary policy decisions.

We think that would actually have very bad effects on markets.

Mrs. BACHMANN. Would the American people be able to know what overnight loans are made, who they are made to, what the collateralization is, would we have that information?

Mr. BERNANKE. We are happy to provide some information on that.

Mrs. BACHMANN. Define "some."

Mr. BERNANKE. There are two classes of loans. There are a whole bunch of programs that were established under emergency authorities. These are now being shut down. We essentially are offering

full transparency on all those programs, including the names of the borrowers.

There is another program which is pretty small in size, but is very important, called a "discount window." The discount window, we think it is very important to keep the names of the borrowers confidential, and the reason is the banks will only come to the discount window in a period of crisis or panic, and if they believe their names will be revealed, that would indeed intensify the crisis or panic, and therefore, the whole purpose of the discount window, to try to eliminate financial panics, would be severely damaged. We are concerned about that.

Mrs. BACHMANN. Mr. Chairman, was the discount window open to private investment banks prior to March 2008?

Mr. BERNANKE. The loans to investment banks were made through an emergency facility and we are opening that.

Mrs. BACHMANN. Was the first time that was opened by the Federal Reserve, the Federal Reserve's discount window, was that in March of 2008 or had the Federal Reserve opened that up prior to that time?

Mr. BERNANKE. The discount window is for banks only. The lending we did to investment banks, we did through an emergency facility, which was opened in March 2008, and which we are offering now complete transparency on.

Mrs. BACHMANN. You are saying there are two discount windows?

Mr. BERNANKE. One of them was an emergency one, which has already been shut down.

Mrs. BACHMANN. The other discount window that is available to banks, that is obviously open, that information, you are saying, we could not have access to?

Mr. BERNANKE. I am concerned that public release of the names of the borrowers would in fact severely damage the function of the discount window, which is to allow liquidity to be put into the system during a period of financial panic.

Mrs. BACHMANN. Another question that I wondered if you could address would be on the GSEs, with Freddie and Fannie, and it appears we may have an attending risk up to $5 trillion. Those are some figures we are hearing, that we are looking at potentially $400 billion directly, but we may have exposure up to $5 trillion.

What are we doing really to limit that risk? It does not seem there has been any appreciable reform of the GSEs, Freddie and Fannie, and it seems like if anything, we are making that situation worse by raising the levels of loans that people can have access to.

What are we doing to protect taxpayer risks?

Mr. BERNANKE. The Federal Reserve for a very long time warned the Congress about the risks of Fannie and Freddie, that we believed they did not have enough capital for their portfolios, and in fact, that has turned out to be the case.

The government's exposure is a couple of billion dollars, which obviously is a large amount of money.

Mrs. BACHMANN. You hold toxic assets on your books now, right?

Mr. BERNANKE. Very little.

Mrs. BACHMANN. What amount is that?

Mr. BERNANKE. About 4 or 5 percent of our balance sheet, about $100 billion.

Mrs. BACHMANN. About $100 billion?

Mr. MINNICK. The gentlewoman's time has expired.

Mrs. BACHMANN. Mr. Chairman, thank you.

Mr. MINNICK. The Chair recognizes the gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you. Mr. Chairman, thank you again for appearing. Thank you for the stamina, because you and I are generally the last guys in the room.

I do want to thank you for being a pretty steady hand during a very difficult time, and the way I would describe it is we had a heart attack, this economy, this financial system had a heart attack in September 2008.

There were a lot of consequences, but we are convalescing now, or we went through a heck of a storm, it is still kind of raining, but not nearly as hard as it was.

I would like to first turn your attention to your slide number 27, and if we could pull up the other slide on unemployment, job loss.

You are looking at your 27 as well as Mr. Foster's slide on job loss. Do you see that?

In your 27, it is more pronounced because the scale is a little different than what he has. Just a sharp drop and then a sharp rise. The loss of unemployment changes dramatically beginning in early 2009. To what do you attribute that?

Mr. BERNANKE. As you pointed out, in the fall of 2008, the world economy essentially had a heart attack and the firms started dropping employees very quickly. There was a sharp contraction of global trade, a sharp contraction of global economic activity. We had minus 6 percent growth in the fourth quarter of 2008 and the first quarter of 2009.

Through a variety of policies, including I would give a lot of credit to Federal Reserve policy, but of course, you can consider me biased, the economy stabilized in the second quarter, and has been growing since then. It was the stabilization—this is the change. This is the number of losses.

When the economy stabilizes, then losses begin to shrink very dramatically. That is what we have seen. We have not yet, of course, seen any actual increases in employment.

Mr. PERLMUTTER. Just looking at the glass-half-full for a second, we were in free fall in terms of jobs. We were just losing jobs at a rate we had not seen. I am not sure we have ever seen job loss at that rate, including in the 1930's. We have reversed that. I would credit monetary policy, the Federal Reserve, also fiscal policy as coming out of this Congress.

My friends on the other side of the aisle, for a while, they were picking on where are the jobs. Well, we have a graph to show they are coming back, which is up there on the wall as well as your slide 27.

Now they have moved onto the next thing, which is the debt. We are not out of the woods yet on jobs, are we, sir?

Mr. BERNANKE. No.

Mr. PERLMUTTER. Part of our debt problem is there was a contraction in the revenues stream to the United States of America.

Mr. BERNANKE. That is right.

Mr. PERLMUTTER. I was kind of listening to a couple of their points. Mr. Hensarling gave us the words from his song, everybody wants to go to heaven, they just do not want to go now. It reminded me of sort of the corollary of that is, John Kaines, who said we are all dead in the long run.

We have to take care of today and today is jobs. We have to put people back to work. I think there has been a complimentary set of policies that are trying to reverse that job loss and to move people into jobs.

My question to you is, how are we getting credit, the smaller banks, community banks, so we can get it to small businesses? That is the big complaint I hear. I think that is where we will get the next surge or we will get a surge of employment, if we can get small businesses really running strong again. How do we do that?

Mr. BERNANKE. On the first point, I am not advocating and I do not think anyone is advocating trying to balance the budget this year or next year. Obviously, there has been a big drop in revenues, a lot of extra expenses.

The issue is trying to have an exit strategy, try to find some years down the road a sustainable fiscal path that will give confidence that we can in fact exit from this extraordinary situation.

I have talked, as you know, a good bit about getting lending going again and talking about supervisory efforts that we are doing.

I think it is worth noting that there was a poll this morning the NFIB put out and asked small firms what their most important problem is. We got an answer which we have seen before which is only 8 percent said credit was their most important problem. The majority of them think weak demand, the weak economy, is the most important problem.

This is not a complete answer to your question, but I do think as we get the economy moving again and strengthening, that is going to make banks more willing to lend and it is going to bring good borrowers to the banks to get credit.

I think just strengthening the economy is going to be a big help. It is important for us as supervisors, and I have mentioned, for example, the various new efforts we are making to get feedback, to get data, to do analyses, to try to make sure our examiners are taking a balanced perspective and are not blocking loans to good creditworthy borrowers. We do not want to make loans to borrowers who cannot pay back, but we do want to make loans to those who are creditworthy. That is an important objective we can continue to work on.

Mr. PERLMUTTER. Thank you.

Mr. MINNICK. The gentleman's time has expired. The Chair recognizes the gentleman from New Jersey, Mr. Garrett, for 5 minutes.

Mr. GARRETT. Perhaps your last questioner for the day. Thank you for being here. Thank you for staying so long. I appreciate the chance to ask you a couple of questions.

The Fed is talking about pulling back on the purchase of mortgage-backed securities. Some experts when they hear that suggest if that does happen, that one of the consequences of that might be

that interest rates will go up some degree. How much, is the question.

If that were to occur, the question then is, what happens to Fannie, Freddie, and the GSEs? Some speculate that if they go up a significant amount or a certain amount, that could have a devastating impact upon their losses at the end of the day.

My first question to you is, considering all that, would it be prudent then for the GSEs today to try to as quickly as possible start to shrink down the size of their portfolio, and if so, then what sort of time frame would be necessary in light of what you project on potentials for interest rates going up?

Mr. BERNANKE. First, we are interested to see what the effect is going to be on mortgage rates. So far, the evidence suggests it will be a modest effect, which would not have a big impact. If you are talking about interest rate risks for the GSEs, I do believe they are mostly hedged by holding treasuries and other securities.

I do not know how much a modest increase in mortgage rates would affect their balance sheet. I do not think it would be catastrophic in any case.

As you know, the arrangements under which Fannie and Freddie were put under conservatorship involved a gradual reduction over time.

Mr. GARRETT. Pretty slow.

Mr. BERNANKE. Pretty slow, in their portfolios. I was asked earlier about what is the right long-term solution for Fannie and Freddie. That obviously needs to be worked out. Many possible outcomes would involve not having a substantial portfolio, so there would have to be a transition into that.

Mr. GARRETT. Working that out, Secretary Geithner is over at the Budget Committee, and that is where we were earlier today, we have a chart over there that shows how much taxpayer money has gone out the window, so to speak, on all the programs, and programs you folks have been working on actually pale in comparison if you saw the red lines we see over at Fannie and Freddie, with the $200 billion and the $400 billion, whether or not you put them on budget or not.

We have a blueprint, if you will, from the Administration, as to where we should go on the regulatory reform. We do not have any blueprint for this.

What sort of time frame should we try to come up with for some solution on this? By the next 6 months, 9 months? A year?

Mr. BERNANKE. I hope so. Chairman Frank said earlier that he had scheduled a March 2nd hearing on the issue. Whether it has been changed, I am not sure. Clearly, you need to be talking about it.

Mr. GARRETT. I know we have an election year. Before the election, I would hope to have this resolved. Is that where you would like to come from on this, if you could?

Mr. BERNANKE. The sooner you get some clarity about what the ultimate objective is, the better. Of course, you do not necessarily have to get there by the end of the year. It is going to take some time to make a transition.

Mr. GARRETT. At least get the plan in place so there is certainty.

Mr. BERNANKE. Right.

Mr. GARRETT. Let me change the subject, with regard to bonds and the Fed issuing bonds. I know there was new authority to the Fed at the end of last year for you to pay interest in reserves, and there was talk about the Fed actually issuing bonds. Then there was a proposal as far as you were creating something called a "term deposit facility."

If I understand it correctly, that would allow a 6-month period of time for the short-term bonds, which is very similar to just regular short-term bond issuance, with the main difference that unlike a bond, the term deposit cannot be traded on the marketplace; right?

First of all, do you have authority to do that?

Mr. BERNANKE. Yes, because it comes under our authority to pay interest on reserves. We cannot sell those deposits to anybody, only to banks who have reserves with us. It is not an open thing; you and I could not purchase them.

Mr. GARRETT. Do you see that in any way coming up to the edge as far as the authority, as far as the Fed being able to issue bonds as skirting the spirit of the law as to what the Fed should be doing when it comes to issuing bonds?

Mr. BERNANKE. No. Congress very appropriately gave us the authority to pay interest on reserves and this is what this would be, only the reserves would be in these accounts. I do not see any issue with it.

I would add, this does not answer your question, but I would add that every central bank in the world, major central bank, has these kinds of authorities, and they are very important for managing short-term interest rates in a period like the present.

Mr. GARRETT. Going back to the beginning part of the question, the initial discussion, at least by some, as far as having the authority to issue bonds that would be just widely circulated or sold in the marketplace—

Mr. BERNANKE. So-called Fed bills.

Mr. GARRETT. Where are you with regard to that?

Mr. BERNANKE. We are not proposing that now.

Mr. GARRETT. Okay. Thank you.

Mr. MINNICK. If the Chairman has just a few more moments, I would like to ask a couple of questions.

During the Reagan Administration and dealing with the problem of commercial bank lending, which we are going to have a hearing on as the chairman said on Friday, in dealing with a similar situation, the Reagan Administration adopted a policy they called "forbearance," which was a temporary reduction in the capital requirements at the discretion of regulators in order to permit banks that were scraping against the very minimum capital levels in the appropriate circumstance to continue to lend.

Do you have an opinion as to the efficacy and appropriateness of that kind of a policy, and if you think it has merit, is it something we should consider in the present circumstance?

Mr. BERNANKE. There are general ideas about setting up a system that would allow capital requirements to vary over the business cycle, during weak periods, that you could run down some capital, for example.

Those so-called countercyclical capital requirements, and those are being discussed. They might be actually a useful innovation.

There is quite a bit of danger, I think, with the forbearance idea because if you begin to allow capital to fall arbitrarily, according to short-run objectives, you might find yourself with the government having to pay a lot of money to bail out banks that have failed because they did not have enough capital.

It is a very delicate issue. I think you are better off if you are going to go that way having a system in place that allows for circumscribed variation over the business cycle and the amount of capital the banks have to hold. A buffer during the good times, they can run it down during the bad times.

Mr. MINNICK. Some variability, depending on the cycle. Would you leave the discretion to institute that variability with the bank regulators or would you provide some legislative side bars?

Mr. BERNANKE. I think the legislation is probably already adequate. It gives the authority to the regulators to set capital standards. I think the regulators could do it through a rulemaking process.

You used the word "discretion." Again, I would not create a system where the regulators could arbitrarily say at any given time you can reduce your capital. I think there ought to be a set of rules that explain exactly how that would happen over time.

Mr. MINNICK. Is implementing such a process that wearing your hat as a bank regulator you have seriously contemplated or would contemplate in this circumstance?

Mr. BERNANKE. Yes. That is being considered in international forums and there are examples around the world, like in Spain, where systems like that seem to have been helpful during the crisis.

Mr. MINNICK. Looking at the other side of financial institutions, balance sheets, one of the complaints I am certain we are going to hear on Friday from commercial banks is that the bank examiners are valuating assets based on the last distressed sale and those values are substantially below current market replacement costs, even discounted for the time anticipated to sell.

Do you think there would be merit in providing guidance by regulators that you could use replacement value discounted to sale as an appropriate valuation for purposes of bank examiner examinations?

Mr. BERNANKE. There is guidance to appraisers in general. I suspect that the principle would be to use true comparables, which would involve not just distressed sales, but other properties as well. I think the main principle would be not to focus on distressed sales as representative of the value of a property.

Mr. MINNICK. Thank you, Mr. Chairman. The gentleman from California has just arrived. We are going to declare him the last speaker and get you out by 2:00 as promised.

The Chair recognizes the gentleman from California, Mr. Campbell, for 5 minutes.

Mr. CAMPBELL. Thank you. Thank you, Chairman Bernanke. I am last and perhaps least as well.

Two questions. One is the public sector, governments at all levels, currently represent, I believe, about 36 percent of GDP, which

is a high since World War II. Governments at all levels are in some trouble. One could say they are overleveraged.

You spoke earlier about the unsustainability of the current debt at the Federal level. My home State of California is obviously in deep fiscal trouble and has been for a long time, and so are many States and local communities.

I have a concern about the public sector kind of being in a position that the private sector was in a few years ago, as being overleveraged, overextended, too much debt, too much spending, and actually the public sector being one of the drags and problems on the economy in the near future.

Your thoughts on that?

Mr. BERNANKE. We have talked in this hearing quite a bit about debt and deficits. I do believe it is very important. It is probably inevitable to have large deficits in the middle of a deep recession, given the loss of revenues and so on.

It is very important to develop a creditable plan for restoring deficits to a sustainable level in the medium term, which I would define to be 3 or 4 years out, and that would mean getting deficits down to something on the order of 3 percent or below, to maintain a stable ratio of debt to GDP.

That is very important to maintain confidence in the debt of the sovereign. Some countries around the world are having some difficulty with that right now. We certainly want to make sure that in the future some time, we will not be put into a situation where our interest payments are so large that it is very difficult for us to make those payments.

Mr. CAMPBELL. Right, and State and local governments have similar problems. They either have to raise taxes, reduce what they are doing, or both as well.

Mr. BERNANKE. That is right.

Mr. CAMPBELL. One more and final question for you is about Fannie Mae and Freddie Mac. If interest rates were to go up broadly, let's say by not 25 basis points, but 200 basis points or something like that, what is the impact?

Are they not carrying a lot of interest rate risk and what is the impact on their bottom line and since they are now taxpayer-owned entities, government-owned entities, what problems do we face there?

Mr. BERNANKE. Mr. Garrett had a similar question. I think I would recommend that you talk directly to the regulator of Fannie and Freddie, but my understanding is they have hedged a good bit of that risk so that they would not be deeply hurt if there was a change in interest rates.

To get an exact answer, you really ought to talk to Mr. DeMarco, who is the acting regulator.

Mr. CAMPBELL. Okay. Thank you, and thank you for everything. I yield back my time.

Mr. MINNICK. The Chair would like to thank Chairman Bernanke for his professionalism, for his time, and for the expertise with which you are carrying out your duties in this very important time for the country. We appreciate you being here.

The Chair also notes that some members may have additional questions which they may wish to submit in writing. Without objec-

tion, the hearing record will remain open for 30 days for members to submit questions to this witness and to place his responses in the record.

The hearing is adjourned.

[Whereupon, at 1:53 p.m., the hearing was adjourned.]

A P P E N D I X

February 24, 2010

OFFICE OF CONGRESSMAN CARSON

Statement of Congressman Carson
Financial Services Committee
"Monetary Policy and the State of the Economy"
February 24, 2010

Thank you, Mr. Chairman, for holding this important hearing today.

It is the time for us to focus on small businesses as they are the businesses that grows this nation. We have shielded corporations with tax payer dollars, while we have done nothing to protect the thousands of the small businesses that continue to shut their doors.

Small businesses are generally the driving force behind most local economies. These small businesses, through their growth, generally are the ones that create the most jobs, thus easing unemployment problems in our communities.

Small businesses are an important source of innovation and progress. The small businesses of today become the larger businesses of tomorrow. Many of our country's top businesses introduced game-changing innovations when they were very small, enabling them to grow very large, thus raising overall productivity.

As we review the small business subsidy proposal, we must ensure there are safeguards in place to prevent gaming of the proposal. Economists have suggested that the subsidy proposal gives small business some incentive to fire some employees and then later to replace them with unemployed workers for whom they can collect the subsidy. The Administration is aware of these risks and has proposed various safeguards. However, new ways will be discovered to maneuver around the restrictions that would reduce the net job creating potential. Let's ensure we close these loopholes and make any legislation we pass effective in helping to grow our economy.

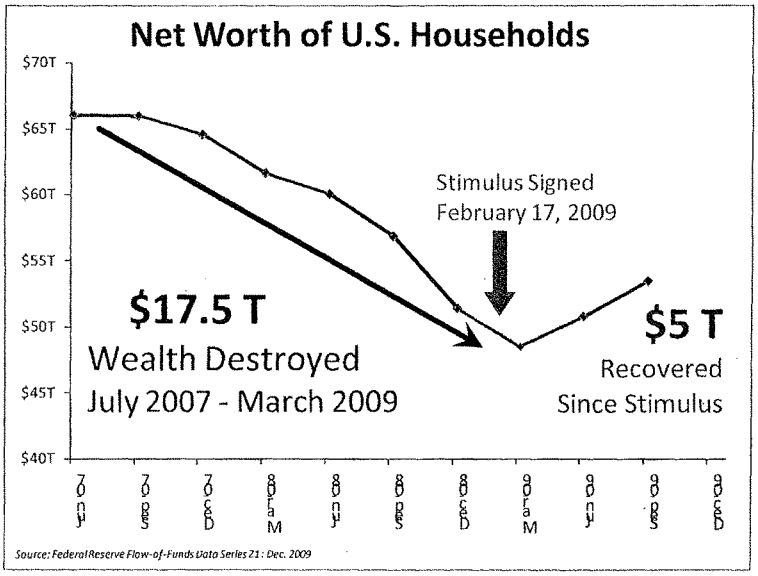
Thank you and I yield back my time.

OPENING STATEMENT – Rep. Bill Foster – House Financial Services Committee Hearing – Feb 24, 2010

As a scientist, I have always found numbers to be more illuminating than ideology and talking points.
So, up on the chart here, I have plotted some interesting numbers that I downloaded from the flow-of-funds report that the Federal Reserve web site reports each quarter.

It shows that from July 2007 to March 2009, (roughly the last year-and-a-half of the previous administration), ***the net worth of households in the United States dropped by 17.5 Trillion dollars***.

Our economy is suffering through the aftermath of the largest destruction of wealth in human history.



Under democratic leadership, since the passage of the stimulus and other important initiatives, this trend has been reversed. Our economy has now stabilized and household net worth has ***increased by more than $5 Trillion dollars***.

The 17.5 Trillion of wealth destroyed in the last months of the previous administration is so large that it is hard to get your arms around. Just how large is 17.5 Trillion dollars?

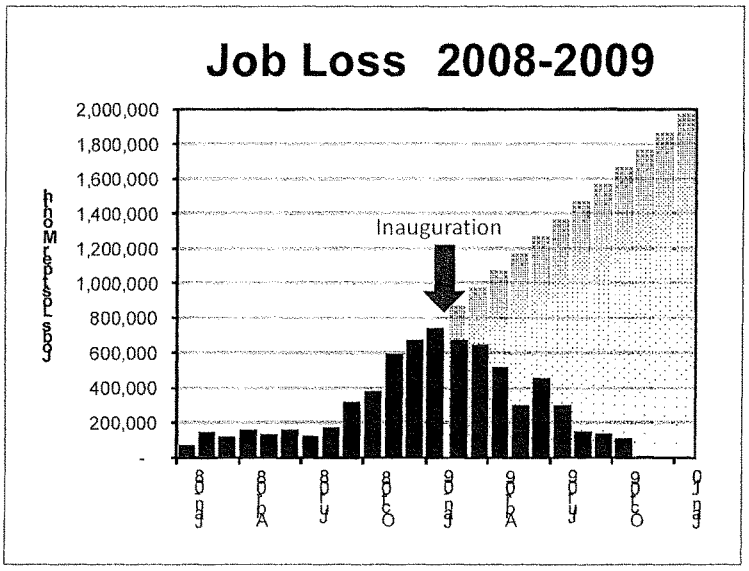
- **$17.5 Trillion is more than 1.4 times larger than the entire U.S. national debt** (roughly $12T).
  So anyone angry about the national debt should be far angrier about the wealth destroyed
- **$17.5 Trillion is more than one year of the U.S. Gross Domestic Product** (roughly $14T). Everyone in the United States would have to work for more than one entire year to recover this $17.5 Trillion of destroyed wealth.
- **$17.5 Trillion is more than $57,000 for every man, woman, and child in the United States.** Think for a moment: how much better off our economy would be today if we each had that $50,000 back?
- Finally, **$17.5 Trillion is about 200 times larger than the anticipated loss in Fannie and Freddie**.

Let's talk for a moment about the *return on investment* of the stimulus. When the dust settles, the total cost to the taxpayers of the stimulus, TARP, and other emergency interventions in our economy, will be roughly 1 Trillion dollars. In response, household wealth has rebounded by $5 Trillion dollars.

Now I'm a businessman as well as a scientist, and it seems to me that an investment of roughly 1 Trillion that generates an increase in wealth of 5 Trillion Dollars represents a pretty good return on investment.

Job Loss and Unemployment

One year ago, over 700,000 jobs were being lost each month and the job loss was increasing by 100,000 more jobs lost every month. The economy was spiraling towards another Great Depression. After the passage of the stimulus and other emergency measures to rescue our economy, job losses started decreasing promptly and job growth is set to turn positive by 2010.



Unfortunately, job recovery always takes longer than people would like. Most downturns last 1-2 years if you look at them in the stock market, and 2-3 years if you look at unemployment. That's the way it is. But it is very difficult for a reasonable person to look at this data and conclude that Democratic policies have not been effective at dealing with job loss.

How did we get here?

It is important to understand that the $17.5T destruction of household wealth that our country just experienced *WAS NOT* the result of a normal business cycle.

It *WAS* the result of an ideology-driven deregulation of the financial markets.

Most importantly, it *WILL HAPPEN AGAIN* if we do not understand and acknowledge what happened and take steps to prevent it from recurring.

U.S. House of Representatives
Committee on Financial Services
Unwinding Emergency Federal Reserve Liquidity Programs and Implications for Economic Recovery
February 24, 2010

Statement for the Record
Congressman Ron Paul

Mr. Chairman, the present economic situation underscores the danger of moral hazard in our financial system. Whether it exists in the form of FDIC coverage, lines of credit to Fannie Mae and Freddie Mac, or outright bailouts, moral hazard is present every time the government attempts to intervene in the financial sector and circumvent the market process.

Since going off commodity-based currency standards, modern economies are completely reliant on trust for their operation. Consumers trust that the dollars they earn will be accepted in exchange, not just today, but decades into the future. They trust that the Federal Reserve will maintain the value of the dollar. They trust that the money in their bank accounts will be there when they need it.

Because of our banking system, however, this trust is misplaced. The dollar is no longer defined as a unit of gold or silver, in fact, it has no definition in US Code at all. A dollar is merely a piece of paper issued by the Federal Reserve with the title "dollar" stamped on it. Since 1913, the Federal Reserve has presided over a 96 percent decline in the dollars value. And FDIC insurance of bank accounts has caused people to become too complacent about their money, oblivious to the fact that the FDIC cannot insure all the money in people's accounts. In the event of a series of major bank failures, the only way to make accountholders whole would be to resort to massive printing of money. This is the problem with a fiat monetary system and fractional reserve banking.

But rather than take our lumps, allow the financial mess to unravel, and return to sound money and sound banking, the Federal Reserve perpetuates the danger by stabilizing our increasingly shaky system through the back door. Far from the prying eyes of auditors, elected representatives, and the American people, the Fed pushes billions and trillions of dollars into the financial system. There is no transparency, no accountability, and worst of all there is the perpetuation of a broken financial system.

Major Wall Street firms will never have any incentive to clean up their acts if they are constantly being bailed out by the government, whether through the Treasury or the Fed. The Fed's actions in shoring up the major banks have given them carte blanche to continue to operate as they did during the boom times, as though nothing is wrong. When the next crisis of confidence rears its head, the financial system will find itself in even worse shape than it was in 2008.

OPENING STATEMENT OF REP. MELVIN WATT

Financial Services Committee Hearing Entitled, "*Monetary Policy and the State of the Economy*"

Wednesday, February 24, 2010

Mr. Chairman: I first want to congratulate Chairman Bernanke on his confirmation for a second term as Chairman of the Federal Reserve Board and welcome him back to the Committee, although I suspect this Committee appearance might not be as cordial as some *Humphrey-Hawkins* appearances have been. This is a tough political environment that has grown more frustrating to all of us as a result of high unemployment, economic despair and growing deficits and debt.

In ordinary times during my tenure on this Committee, these semi-annual *Humphrey-Hawkins* hearings have focused almost exclusively on the Fed's use of interest rate changes to impact economic activity and control inflation. However, these are not ordinary times. Inflation remains a non-issue at only 0.2% as of January 2010. It is obvious that short-term concerns about inflation must, for the time, take a back seat to urgent concerns about continuing job losses.

The Federal Reserve Act of 1913 and Federal Reserve Act Amendments of 1977 require the Fed to pursue a "dual mandate" of fostering maximum sustainable employment and stable prices. The "stable prices" part of this mandate will not, and probably should not, receive much attention today. I was often at odds with former Chairman Greenspan about his and other economists' notion that that there is some "natural rate of unemployment" of around 4.5%. I simply never accepted the notion that any percentage of unemployment was acceptable when there were people who wanted and needed to work. Now at least 9.7% of the people who want to work can't find jobs and I doubt that anyone would argue that this is acceptable. Unfortunately, in urban and minority communities, the unemployment rate is even higher and this saps the potential of millions of people to contribute to the national economy and lead productive lives.

These are indeed perilous times. Some labor experts estimate that 6.3 million Americans have been unemployed for 6 months or longer and that the economy needs at least 100,000 new jobs a month just to absorb new entrants into the labor force. Who knows how many people have given up looking for work and are no longer counted in unemployment statistics?

With more than 15 million people officially jobless, it is likely that even a strong recovery will leave many jobless for years. We could be perilously close to creating a class of "permanently unemployed." Behind these statistics are painful stories of real people with dreams and aspirations to provide for their families and contribute to their communities. They simply can't fulfill those aspirations without jobs.

Against this backdrop, the question I really need to have addressed today is what tools the Fed has in its toolkit to reverse the trends and spur job growth in the 12th District of North Carolina and elsewhere in America. I asked a similar question at last year's *Humphrey-Hawkins* hearing and, at that time, Chairman Bernanke vowed to take "strong and aggressive" action to halt the economic slide and improve job growth. One year later, unemployment has gotten worse, although there are small signs of recovery. Today, I hope to hear specifics on the Fed's plans to spur job growth and meet the other half of its dual mandate -- fostering maximum sustainable employment. If there are things Congress can and should do to help, I stand ready to help.

For release on delivery
10 a.m. EST
February 24, 2010

Semiannual Monetary Policy Report to the Congress

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 24, 2010

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress.* I will begin today with some comments on the outlook for the economy and for monetary policy, then touch briefly on several other important issues.

The Economic Outlook

Although the recession officially began more than two years ago, U.S. economic activity contracted particularly sharply following the intensification of the global financial crisis in the fall of 2008. Concerted efforts by the Federal Reserve, the Treasury Department, and other U.S. authorities to stabilize the financial system, together with highly stimulative monetary and fiscal policies, helped arrest the decline and are supporting a nascent economic recovery. Indeed, the U.S. economy expanded at about a 4 percent annual rate during the second half of last year. A significant portion of that growth, however, can be attributed to the progress firms made in working down unwanted inventories of unsold goods, which left them more willing to increase production. As the impetus provided by the inventory cycle is temporary, and as the fiscal support for economic growth likely will diminish later this year, a sustained recovery will depend on continued growth in private-sector final demand for goods and services.

Private final demand does seem to be growing at a moderate pace, buoyed in part by a general improvement in financial conditions. In particular, consumer spending has recently picked up, reflecting gains in real disposable income and household wealth and tentative signs of stabilization in the labor market. Business investment in equipment and software has risen significantly. And international trade--supported by a recovery in the economies of many of our trading partners--is rebounding from its deep contraction of a year ago. However, starts of single-family homes, which rose noticeably this past spring, have recently been roughly flat, and

commercial construction is declining sharply, reflecting poor fundamentals and continued difficulty in obtaining financing.

The job market has been hit especially hard by the recession, as employers reacted to sharp sales declines and concerns about credit availability by deeply cutting their workforces in late 2008 and in 2009. Some recent indicators suggest the deterioration in the labor market is abating: Job losses have slowed considerably, and the number of full-time jobs in manufacturing rose modestly in January. Initial claims for unemployment insurance have continued to trend lower, and the temporary services industry, often considered a bellwether for the employment outlook, has been expanding steadily since October. Notwithstanding these positive signs, the job market remains quite weak, with the unemployment rate near 10 percent and job openings scarce. Of particular concern, because of its long-term implications for workers' skills and wages, is the increasing incidence of long-term unemployment; indeed, more than 40 percent of the unemployed have been out of work six months or more, nearly double the share of a year ago.

Increases in energy prices resulted in a pickup in consumer price inflation in the second half of last year, but oil prices have flattened out over recent months, and most indicators suggest that inflation likely will be subdued for some time. Slack in labor and product markets has reduced wage and price pressures in most markets, and sharp increases in productivity have further reduced producers' unit labor costs. The cost of shelter, which receives a heavy weight in consumer price indexes, is rising very slowly, reflecting high vacancy rates. In addition, according to most measures, longer-term inflation expectations have remained relatively stable.

The improvement in financial markets that began last spring continues. Conditions in short-term funding markets have returned to near pre-crisis levels. Many (mostly larger) firms

have been able to issue corporate bonds or new equity and do not seem to be hampered by a lack of credit. In contrast, bank lending continues to contract, reflecting both tightened lending standards and weak demand for credit amid uncertain economic prospects.

In conjunction with the January meeting of the Federal Open Market Committee (FOMC), Board members and Reserve Bank presidents prepared projections for economic growth, unemployment, and inflation for the years 2010 through 2012 and over the longer run. The contours of these forecasts are broadly similar to those I reported to the Congress last July. FOMC participants continue to anticipate a moderate pace of economic recovery, with economic growth of roughly 3 to 3-1/2 percent in 2010 and 3-1/2 to 4-1/2 percent in 2011. Consistent with moderate economic growth, participants expect the unemployment rate to decline only slowly, to a range of roughly 6-1/2 to 7-1/2 percent by the end of 2012, still well above their estimate of the long-run sustainable rate of about 5 percent. Inflation is expected to remain subdued, with consumer prices rising at rates between 1 and 2 percent in 2010 through 2012. In the longer term, inflation is expected to be between 1-3/4 and 2 percent, the range that most FOMC participants judge to be consistent with the Federal Reserve's dual mandate of price stability and maximum employment.

Monetary Policy

Over the past year, the Federal Reserve has employed a wide array of tools to promote economic recovery and preserve price stability. The target for the federal funds rate has been maintained at a historically low range of 0 to 1/4 percent since December 2008. The FOMC continues to anticipate that economic conditions--including low rates of resource utilization, subdued inflation trends, and stable inflation expectations--are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. We have been gradually slowing the pace of these purchases in order to promote a smooth transition in markets and anticipate that these transactions will be completed by the end of March. The FOMC will continue to evaluate its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

In response to the substantial improvements in the functioning of most financial markets, the Federal Reserve is winding down the special liquidity facilities it created during the crisis. On February 1, a number of these facilities, including credit facilities for primary dealers, lending programs intended to help stabilize money market mutual funds and the commercial paper market, and temporary liquidity swap lines with foreign central banks, were allowed to expire.[1] The only remaining lending program for multiple borrowers created under the Federal Reserve's emergency authorities, the Term Asset-Backed Securities Loan Facility, is scheduled to close on March 31 for loans backed by all types of collateral except newly issued commercial mortgage-backed securities (CMBS) and on June 30 for loans backed by newly issued CMBS.

In addition to closing its special facilities, the Federal Reserve is normalizing its lending to commercial banks through the discount window. The final auction of discount-window funds to depositories through the Term Auction Facility, which was created in the early stages of the crisis to improve the liquidity of the banking system, will occur on March 8. Last week we announced that the maximum term of discount window loans, which was increased to as much as 90 days during the crisis, would be returned to overnight for most banks, as it was before the

[1] Primary dealers are broker-dealers that act as counterparties to the Federal Reserve Bank of New York in its conduct of open market operations.

crisis erupted in August 2007. To discourage banks from relying on the discount window rather than private funding markets for short-term credit, last week we also increased the discount rate by 25 basis points, raising the spread between the discount rate and the top of the target range for the federal funds rate to 50 basis points. These changes, like the closure of most of the special lending facilities earlier this month, are in response to the improved functioning of financial markets, which has reduced the need for extraordinary assistance from the Federal Reserve. These adjustments are not expected to lead to tighter financial conditions for households and businesses and should not be interpreted as signaling any change in the outlook for monetary policy, which remains about the same as it was at the time of the January meeting of the FOMC.

Although the federal funds rate is likely to remain exceptionally low for an extended period, as the expansion matures, the Federal Reserve will at some point need to begin to tighten monetary conditions to prevent the development of inflationary pressures. Notwithstanding the substantial increase in the size of its balance sheet associated with its purchases of Treasury and agency securities, we are confident that we have the tools we need to firm the stance of monetary policy at the appropriate time.[2]

Most importantly, in October 2008 the Congress gave statutory authority to the Federal Reserve to pay interest on banks' holdings of reserve balances at Federal Reserve Banks. By increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates. Actual and prospective increases in short-term interest rates will be reflected in turn in longer-term interest rates and in financial conditions more generally.

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[2] For further details on these tools and the Federal Reserve's exit strategy, see Ben S. Bernanke (2010), "Federal Reserve's Exit Strategy," statement before the Committee on Financial Services, U.S. House of Representatives, February 10, www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm.

The Federal Reserve has also been developing a number of additional tools to reduce the large quantity of reserves held by the banking system, which will improve the Federal Reserve's control of financial conditions by leading to a tighter relationship between the interest rate paid on reserves and other short-term interest rates. Notably, our operational capacity for conducting reverse repurchase agreements, a tool that the Federal Reserve has historically used to absorb reserves from the banking system, is being expanded so that such transactions can be used to absorb large quantities of reserves.[3] The Federal Reserve is also currently refining plans for a term deposit facility that could convert a portion of depository institutions' holdings of reserve balances into deposits that are less liquid and could not be used to meet reserve requirements.[4] In addition, the FOMC has the option of redeeming or selling securities as a means of reducing outstanding bank reserves and applying monetary restraint. Of course, the sequencing of steps and the combination of tools that the Federal Reserve uses as it exits from its currently very accommodative policy stance will depend on economic and financial developments. I provided more discussion of these options and possible sequencing in a recent testimony.[5]

Federal Reserve Transparency

The Federal Reserve is committed to ensuring that the Congress and the public have all the information needed to understand our decisions and to be assured of the integrity of our operations. Indeed, on matters related to the conduct of monetary policy, the Federal Reserve is

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[3] The Federal Reserve has recently developed the ability to engage in reverse repurchase agreements in the triparty market for repurchase agreements, with primary dealers as counterparties and using Treasury and agency debt securities as collateral, and it is developing the capacity to carry out these transactions with a wider set of counterparties (such as money market mutual funds and the mortgage-related government-sponsored enterprises) and using agency mortgage-backed securities as collateral.

[4] In December the Federal Reserve published a proposal describing a term deposit facility in the *Federal Register* (see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Board Proposes Amendments to Regulation D That Would Enable the Establishment of a Term Deposit Facility," press release, December 28, www.federalreserve.gov/newsevents/press/monetary/20091228a.htm). We are now in the process of analyzing the public comments that have been received. A revised proposal will be reviewed by the Federal Reserve Board, and test transactions could commence during the second quarter.

[5] See Bernanke, "Federal Reserve's Exit Strategy," in note 2.

already one of the most transparent central banks in the world, providing detailed records and explanations of its decisions. Over the past year, the Federal Reserve also took a number of steps to enhance the transparency of its special credit and liquidity facilities, including the provision of regular, extensive reports to the Congress and the public; and we have worked closely with the Government Accountability Office (GAO), the Office of the Special Inspector General for the Troubled Asset Relief Program, the Congress, and private-sector auditors on a range of matters relating to these facilities.

While the emergency credit and liquidity facilities were important tools for implementing monetary policy during the crisis, we understand that the unusual nature of those facilities creates a special obligation to assure the Congress and the public of the integrity of their operation. Accordingly, we would welcome a review by the GAO of the Federal Reserve's management of all facilities created under emergency authorities.[6] In particular, we would support legislation authorizing the GAO to audit the operational integrity, collateral policies, use of third-party contractors, accounting, financial reporting, and internal controls of these special credit and liquidity facilities. The Federal Reserve will, of course, cooperate fully and actively in all reviews. We are also prepared to support legislation that would require the release of the identities of the firms that participated in each special facility after an appropriate delay. It is important that the release occur after a lag that is sufficiently long that investors will not view an institution's use of one of the facilities as a possible indication of ongoing financial problems, thereby undermining market confidence in the institution or discouraging use of any future

[6] Last month the Federal Reserve said that it would welcome a full review by the GAO of all aspects of the Federal Reserve's involvement in the extension of credit to the American International Group, Inc. (see Ben S. Bernanke (2010), letter to Gene L. Dodaro, January 19, www.federalreserve.gov/monetarypolicy/files/letter_aig_20100119.pdf). The Federal Reserve would support legislation authorizing a review by the GAO of the Federal Reserve's operations of its facilities created under emergency authorities: the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, the Primary Dealer Credit Facility, the Term Asset-Backed Securities Loan Facility, and the Term Securities Lending Facility.

facility that might become necessary to protect the U.S. economy. An appropriate delay would also allow firms adequate time to inform investors through annual reports and other public documents of their use of Federal Reserve facilities.

Looking ahead, we will continue to work with the Congress in identifying approaches for enhancing the Federal Reserve's transparency that are consistent with our statutory objectives of fostering maximum employment and price stability. In particular, it is vital that the conduct of monetary policy continue to be insulated from short-term political pressures so that the FOMC can make policy decisions in the longer-term economic interests of the American people. Moreover, the confidentiality of discount window lending to individual depository institutions must be maintained so that the Federal Reserve continues to have effective ways to provide liquidity to depository institutions under circumstances where other sources of funding are not available. The Federal Reserve's ability to inject liquidity into the financial system is critical for preserving financial stability and for supporting depositories' key role in meeting the ongoing credit needs of firms and households.

Regulatory Reform

Strengthening our financial regulatory system is essential for the long-term economic stability of the nation. Among the lessons of the crisis are the crucial importance of macroprudential regulation--that is, regulation and supervision aimed at addressing risks to the financial system as a whole--and the need for effective consolidated supervision of every financial institution that is so large or interconnected that its failure could threaten the functioning of the entire financial system.

The Federal Reserve strongly supports the Congress's ongoing efforts to achieve comprehensive financial reform. In the meantime, to strengthen the Federal Reserve's oversight

of banking organizations, we have been conducting an intensive self-examination of our regulatory and supervisory responsibilities and have been actively implementing improvements. For example, the Federal Reserve has been playing a key role in international efforts to toughen capital and liquidity requirements for financial institutions, particularly systemically critical firms, and we have been taking the lead in ensuring that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking.[7]

The Federal Reserve is also making fundamental changes in its supervision of large, complex bank holding companies, both to improve the effectiveness of consolidated supervision and to incorporate a macroprudential perspective that goes beyond the traditional focus on safety and soundness of individual institutions. We are overhauling our supervisory framework and procedures to improve coordination within our own supervisory staff and with other supervisory agencies and to facilitate more-integrated assessments of risks within each holding company and across groups of companies.

Last spring the Federal Reserve led the successful Supervisory Capital Assessment Program, popularly known as the bank stress tests. An important lesson of that program was that combining on-site bank examinations with a suite of quantitative and analytical tools can greatly improve comparability of the results and better identify potential risks. In that spirit, the Federal Reserve is also in the process of developing an enhanced quantitative surveillance program for large bank holding companies. Supervisory information will be combined with firm-level, market-based indicators and aggregate economic data to provide a more complete picture of the risks facing these institutions and the broader financial system. Making use of the Federal Reserve's unparalleled breadth of expertise, this program will apply a multidisciplinary approach

[7] For further information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

that involves economists, specialists in particular financial markets, payments systems experts, and other professionals, as well as bank supervisors.

The recent crisis has also underscored the extent to which direct involvement in the oversight of banks and bank holding companies contributes to the Federal Reserve's effectiveness in carrying out its responsibilities as a central bank, including the making of monetary policy and the management of the discount window. Most important, as the crisis has once again demonstrated, the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.

The Federal Reserve continues to demonstrate its commitment to strengthening consumer protections in the financial services arena. Since the time of the previous *Monetary Policy Report* in July, the Federal Reserve has proposed a comprehensive overhaul of the regulations governing consumer mortgage transactions, and we are collaborating with the Department of Housing and Urban Development to assess how we might further increase transparency in the mortgage process.[8] We have issued rules implementing enhanced consumer protections for credit card accounts and private student loans as well as new rules to ensure that consumers have meaningful opportunities to avoid overdraft fees.[9] In addition, the Federal Reserve has

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[8] For further information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Proposes Significant Changes to Regulation Z (Truth in Lending) Intended to Improve the Disclosures Consumers Receive in Connection with Closed-End Mortgages and Home-Equity Lines of Credit," press release, July 23, www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm.

[9] For more information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Approves Final Amendments to Regulation Z That Revise Disclosure Requirements for Private Education Loans," press release, July 30, www.federalreserve.gov/newsevents/press/bcreg/20090730a.htm; Board of Governors of the Federal Reserve System (2009), "Federal Reserve Announces Final Rules Prohibiting Institutions from Charging Fees for Overdrafts on ATM and One-Time Debit Card Transactions," press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20091112a.htm; and Board of Governors of the Federal Reserve System (2010), "Federal Reserve Approves Final Rules to Protect Credit Card Users from a Number of Costly Practices," press release, January 12, www.federalreserve.gov/newsevents/press/bcreg/20100112a.htm.

implemented an expanded consumer compliance supervision program for nonbank subsidiaries of bank holding companies and foreign banking organizations.[10]

More generally, the Federal Reserve is committed to doing all that can be done to ensure that our economy is never again devastated by a financial collapse. We look forward to working with the Congress to develop effective and comprehensive reform of the financial regulatory framework.

[10] For further information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve to Implement Consumer Compliance Supervision Program of Nonbank Subsidiaries of Bank Holding Companies and Foreign Banking Organizations," press release, September 15, www.federalreserve.gov/newsevents/press/bcreg/20090915a.htm.

FINAL VOTE RESULTS FOR ROLL CALL 681

(Democrats in roman; Republicans in *italic*; Independents underlined)

H R 1424 YEA-AND-NAY 3-Oct-2008 1:22 PM
QUESTION: On Motion to Concur in Senate Amendments
BILL TITLE: Emergency Economic Stabilization Act of 2008

	YEAS	NAYS	PRES	NV
DEMOCRATIC	172	63		
REPUBLICAN	91	108		
INDEPENDENT				
TOTALS	**263**	**171**		

---- YEAS 263 ---

Abercrombie	Foster	Pallone
Ackerman	Frank (MA)	Pascrell
Alexander	*Frelinghuysen*	Pastor
Allen	*Gerlach*	Pelosi
Andrews	Giffords	Perlmutter
Arcuri	*Gilchrest*	*Peterson (PA)*
Baca	Gonzalez	*Pickering*
Bachus	Gordon	Pomeroy
Baird	*Granger*	*Porter*
Baldwin	Green, Al	Price (NC)
Barrett (SC)	Gutierrez	*Pryce (OH)*
Bean	Hall (NY)	*Putnam*
Berkley	Hare	*Radanovich*
Berman	Harman	Rahall
Berry	Hastings (FL)	*Ramstad*
Biggert	*Herger*	Rangel
Bishop (GA)	Higgins	*Regula*
Bishop (NY)	Hinojosa	Reyes
Blunt	Hirono	*Reynolds*
Boehner	*Hobson*	Richardson
Bonner	*Hoekstra*	*Rogers (AL)*
Bono Mack	Holt	*Rogers (KY)*
Boozman	Honda	*Ros-Lehtinen*
Boren	Hooley	Ross
Boswell	Hoyer	Ruppersberger
Boucher	*Inglis (SC)*	Rush
Boustany	Israel	Ryan (OH)
Boyd (FL)	Jackson (IL)	*Ryan (WI)*
Brady (PA)	Jackson-Lee (TX)	Sarbanes
Brady (TX)	Johnson, E. B.	*Saxton*
Braley (IA)	Kanjorski	Schakowsky

Brown (SC)	Kennedy	Schiff
Brown, Corrine	Kildee	*Schmidt*
Buchanan	Kilpatrick	Schwartz
Calvert	Kind	Scott (GA)
Camp (MI)	*King (NY)*	*Sessions*
Campbell (CA)	*Kirk*	Sestak
Cannon	Klein (FL)	*Shadegg*
Cantor	*Kline (MN)*	*Shays*
Capps	*Knollenberg*	*Shuster*
Capuano	*Kuhl (NY)*	*Simpson*
Cardoza	*LaHood*	Sires
Carnahan	Langevin	Skelton
Carson	Larsen (WA)	Slaughter
Castle	Larson (CT)	*Smith (TX)*
Clarke	Lee	Smith (WA)
Cleaver	Levin	Snyder
Clyburn	*Lewis (CA)*	Solis
Coble	Lewis (GA)	*Souder*
Cohen	*Lewis (KY)*	Space
Cole (OK)	Loebsack	Speier
Conaway	Lofgren, Zoe	Spratt
Cooper	Lowey	*Sullivan*
Costa	*Lungren, Daniel E.*	Sutton
Cramer	Mahoney (FL)	*Tancredo*
Crenshaw	Maloney (NY)	Tanner
Crowley	Markey	Tauscher
Cubin	Marshall	*Terry*
Cuellar	Matsui	Thompson (CA)
Cummings	McCarthy (NY)	*Thornberry*
Davis (AL)	McCollum (MN)	*Tiberi*
Davis (CA)	*McCrery*	Tierney
Davis (IL)	McGovern	Towns
Davis, Tom	*McHugh*	Tsongas
DeGette	*McKeon*	*Upton*
DeLauro	McNerney	Van Hollen
Dent	McNulty	Velázquez
Dicks	Meek (FL)	*Walden (OR)*
Dingell	Meeks (NY)	*Walsh (NY)*
Donnelly	Melancon	*Wamp*
Doyle	Miller (NC)	Wasserman Schultz
Dreier	*Miller, Gary*	Waters
Edwards (MD)	Miller, George	Watson
Edwards (TX)	Mitchell	Watt
Ehlers	Mollohan	Waxman
Ellison	Moore (KS)	Weiner
Ellsworth	Moore (WI)	Welch (VT)
Emanuel	Moran (VA)	*Weldon (FL)*
Emerson	Murphy (CT)	*Weller*
Engel	Murphy, Patrick	Wexler
Eshoo	Murtha	*Wilson (NM)*

Etheridge	*Myrick*	Wilson (OH)
Everett	Nadler	*Wilson (SC)*
Fallin	Neal (MA)	*Wolf*
Farr	Oberstar	Woolsey
Fattah	Obey	Wu
Ferguson	Olver	Yarmuth
Fossella	Ortiz	

---- NAYS 171 ---

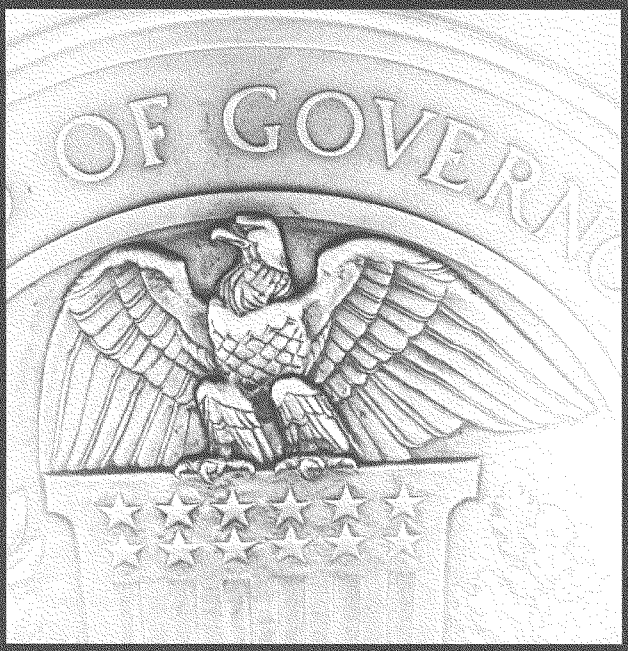
Aderholt	*Gohmert*	*Moran (KS)*
Akin	*Goode*	*Murphy, Tim*
Altmire	*Goodlatte*	*Musgrave*
Bachmann	*Graves*	Napolitano
Barrow	Green, Gene	*Neugebauer*
Bartlett (MD)	Grijalva	*Nunes*
Barton (TX)	*Hall (TX)*	*Paul*
Becerra	*Hastings (WA)*	Payne
Bilbray	*Hayes*	*Pearce*
Bilirakis	*Heller*	*Pence*
Bishop (UT)	*Hensarling*	Peterson (MN)
Blackburn	Herseth Sandlin	*Petri*
Blumenauer	Hill	*Pitts*
Boyda (KS)	Hinchey	*Platts*
Broun (GA)	Hodes	*Poe*
Brown-Waite, Ginny	Holden	*Price (GA)*
Burgess	*Hulshof*	*Rehberg*
Burton (IN)	*Hunter*	*Reichert*
Butterfield	Inslee	*Renzi*
Buyer	*Issa*	Rodriguez
Capito	Jefferson	*Rogers (MI)*
Carney	Johnson (GA)	*Rohrabacher*
Carter	*Johnson (IL)*	*Roskam*
Castor	*Johnson, Sam*	Rothman
Cazayoux	*Jones (NC)*	Roybal-Allard
Chabot	*Jordan*	*Royce*
Chandler	Kagen	Salazar
Childers	Kaptur	*Sali*
Clay	*Keller*	Sánchez, Linda T.
Conyers	*King (IA)*	Sanchez, Loretta
Costello	*Kingston*	*Scalise*
Courtney	Kucinich	Scott (VA)
Culberson	*Lamborn*	*Sensenbrenner*
Davis (KY)	Lampson	Serrano
Davis, David	*Latham*	Shea-Porter
Davis, Lincoln	*LaTourette*	Sherman
Deal (GA)	*Latta*	*Shimkus*
DeFazio	*Linder*	Shuler
Delahunt	Lipinski	*Smith (NE)*

Diaz-Balart, L.	*LoBiondo*	*Smith (NJ)*
Diaz-Balart, M.	*Lucas*	Stark
Doggett	Lynch	*Stearns*
Doolittle	*Mack*	Stupak
Drake	*Manzullo*	Taylor
Duncan	*Marchant*	Thompson (MS)
English (PA)	Matheson	*Tiahrt*
Feeney	*McCarthy (CA)*	*Turner*
Filner	*McCaul (TX)*	Udall (CO)
Flake	*McCotter*	Udall (NM)
Forbes	McDermott	Visclosky
Fortenberry	*McHenry*	*Walberg*
Foxx	McIntyre	Walz (MN)
Franks (AZ)	*McMorris Rodgers*	*Westmoreland*
Gallegly	*Mica*	*Whitfield (KY)*
Garrett (NJ)	Michaud	*Wittman (VA)*
Gillibrand	*Miller (FL)*	*Young (AK)*
Gingrey	*Miller (MI)*	*Young (FL)*

For use at 10:00 a.m., EST
February 24, 2010

Monetary Policy Report to the Congress

February 24, 2010



Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

February 24, 2010

Board of Governors of the Federal Reserve System

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., February 24, 2010

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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Part 1
Overview: Monetary Policy and the Economic Outlook

After declining for a year and a half, economic activity in the United States turned up in the second half of 2009, supported by an improvement in financial conditions, stimulus from monetary and fiscal policies, and a recovery in foreign economies. These factors, along with increased business and household confidence, appear likely to boost spending and sustain the economic expansion. However, the pace of the recovery probably will be tempered by households' desire to rebuild wealth, still-tight credit conditions facing some borrowers, and, despite some tentative signs of stabilization, continued weakness in labor markets. With substantial resource slack continuing to suppress cost pressures and with longer-term inflation expectations stable, inflation is likely to be subdued for some time.

U.S. real gross domestic product (GDP) rose at about a 4 percent pace, on average, over the second half of 2009. Consumer spending—which was boosted by supportive monetary and fiscal policies—posted solid increases, though it remained well below its pre-recession level. Meanwhile, activity in the housing market, which began to pick up last spring, flattened over the second half of 2009. In the business sector, investment in equipment and software posted a sizable gain in the second half of last year, likely reflecting improved conditions in capital markets and brighter sales prospects. In addition, firms reduced the pace of inventory liquidation markedly in the fourth quarter. In contrast, investment in nonresidential structures continued to contract. With the recovery in U.S. and foreign demand, U.S. trade flows rebounded in the second half of 2009 after precipitous declines late in 2008 and early in 2009. Nevertheless, both exports and imports stayed considerably below their earlier peaks.

Despite the pickup in output, employment continued to contract in the second half of 2009, albeit at a markedly slower pace than in the first half. The unemployment rate rose further during the second half, reaching 10 percent by the end of the year—its highest level since the early 1980s—before dropping back in January. Although job losses have slowed, hiring remains weak, and the median duration of unemployment has lengthened significantly.

Headline consumer price inflation picked up in 2009 as energy prices rose sharply: Over the 12 months ending in December, prices for personal consumption expenditures (PCE) increased about 2 percent, up from ½ percent in 2008. In contrast, price increases for consumer expenditures other than food and energy items—so-called core PCE—slowed noticeably last year. After rising at an annual rate of about 1¾ percent in 2008 and the first half of 2009, core PCE prices increased at an annual rate of just over 1 percent in the second half of the year.

The recovery in financial markets that began last spring continued through the second half of the year and into 2010. Broad equity price indexes increased further, on balance, and risk spreads on corporate bonds narrowed considerably. Conditions in short-term funding markets returned to near pre-crisis levels; liquidity and pricing in bank funding markets continued to normalize, while risk spreads in the commercial paper market were stable at the low end of the range observed since the fall of 2007. The functioning of financial markets more generally improved further.

Investors became more optimistic about the outlook for financial institutions during the first half of last year. That development was bolstered by the release of the results of the Supervisory Capital Assessment Program (SCAP), which were seen as helping clarify the financial conditions of the largest bank holding companies and provided investors with greater assurance about the health of the institutions. Sentiment rose further over the remainder of the year as investors became more optimistic about the economic outlook. Most of the 19 bank holding companies included in the SCAP issued equity, some to augment or improve the quality of their capital and some to repay investments made by the Treasury under the Troubled Asset Relief Program. Still, delinquency and charge-off rates at commercial banks increased further in the second half of the year, and loan losses remained very high.

Nonfinancial firms with access to capital markets took advantage of the improvement in financial conditions to issue corporate bonds and equity shares at a solid pace; a significant portion of issuance likely reflected an effort by businesses to substitute attractively priced

longer-term financing for shorter-term debt. In contrast, many small businesses and other firms that depend largely on banks to meet their funding needs found their access to credit severely restricted; banks continued to tighten their lending standards and terms, though to a more limited extent, during the second half of 2009 amid higher loan losses on their commercial loans and reports of lingering uncertainty about business credit quality. According to survey data, demand for business loans was also weak throughout 2009.

Availability of credit for households remained constrained in the second half of 2009, even as interest rates declined for mortgages and many consumer loans. Restrictive bank lending policies to individuals likely were due importantly to banks' concerns about the ability of households to repay loans in an environment of high unemployment and continued softness in house prices. In addition, senior bank loan officers reported weakening loan demand from households throughout 2009. However, in part because of support from the Federal Reserve's Term Asset-Backed Securities Loan Facility, the consumer asset-backed securities market, which is an important funding source for consumer loans, improved. All told, in 2009 nominal household debt experienced its first annual decline since the beginning of the data series in 1951.

The Federal Reserve continued to support the functioning of financial markets and promote recovery in economic activity using a wide array of tools. The Federal Open Market Committee (FOMC) maintained a target range of 0 to ¼ percent for the federal funds rate throughout the second half of 2009 and early 2010 and indicated that economic conditions were likely to warrant exceptionally low levels of the federal funds rate for an extended period. Further, the Federal Reserve continued its purchases of Treasury securities, agency mortgage-backed securities (MBS), and agency debt in order to provide support to mortgage and housing markets and to improve overall conditions in private credit markets. To promote a smooth transition in financial markets as the acquisitions are completed, the Federal Reserve gradually slowed the pace of these purchases in late 2009 and early 2010. The planned acquisitions of $300 billion of Treasury securities were completed by October, while the purchases of $1.25 trillion of MBS and about $175 billion of agency debt are expected to be finished by the end of the first quarter of this year.

In light of the improved functioning of financial markets, the Federal Reserve removed some of the extraordinary support it had provided during the crisis and closed many of its special liquidity facilities and the temporary liquidity swap arrangements with other central banks in the fall of 2009 and early in 2010. The Federal Reserve also began to normalize its lending to commercial banks through the discount window by reducing the maximum maturity of loans extended through the primary credit facility from 90 days to 28 days, effective on January 14, and by announcing that the maturity of those loans will be reduced further to overnight, effective on March 18. The rate charged on primary credit loans was increased from ½ percent to ¾ percent effective February 19. In addition, the Federal Reserve announced that the final auction under the Term Auction Facility will occur in March and later noted that the minimum bid rate for that auction had been increased by ¼ percentage point to ½ percent. Overall, the size of the Federal Reserve's balance sheet increased from about $2 trillion in the summer of 2009 to about $2.3 trillion on February 17, 2010. The composition of the balance sheet continued to shift as a considerable decline in credit extended through various facilities was more than offset by the increase in securities held outright. The Federal Reserve continued to broaden its efforts to provide even more information to the public regarding its conduct of these programs and of monetary policy (see box in Part 3).

The Federal Reserve is taking steps to ensure that it will be able to smoothly withdraw extraordinary policy accommodation when appropriate. Because the Federal Reserve, under the statutory authority provided by the Congress in October 2008, pays interest on the balances depository institutions hold at Reserve Banks, it can put upward pressure on short-term interest rates even with an extraordinarily large volume of reserves in the banking system by raising the interest rate paid on such balances. In addition, the Federal Reserve has continued to develop several other tools that it could use to reinforce the effects of increases in the interest rate on balances at Reserve Banks. In particular, the Federal Reserve has tested its ability to execute reverse repurchase agreements (reverse repos) in the triparty repo market with primary dealers using both Treasury and agency debt as collateral, and it is developing the capability to conduct such transactions with other counterparties and against agency MBS. The Federal Reserve has also announced plans for implementing a term deposit facility. In addition, it has the option of redeeming or selling assets in order to reduce monetary policy accommodation.

In conjunction with the January 2010 FOMC meeting, the members of the Board of Governors of the Federal Reserve System and presidents of the Federal Reserve Banks, all of whom participate in FOMC meetings, provided projections for economic growth, unemployment, and inflation; these projections are presented

in Part 4 of this report. FOMC participants agreed that economic recovery from the recent recession was under way, but that they expected it to proceed at a gradual pace, restrained in part by household and business uncertainty regarding the economic outlook, modest improvement in labor markets, and slow easing of credit conditions in the banking sector. Participants expected that real GDP would expand at a rate that was only moderately above its longer-run sustainable growth rate and that the unemployment rate would decline only slowly over the next few years. Most participants also anticipated that inflation would remain subdued over this period.

Nearly all participants judged the risks to their growth outlook as generally balanced, and most also saw roughly balanced risks surrounding their inflation projections. Participants continued to judge the uncertainty surrounding their projections for economic activity and inflation as unusually high relative to historical norms. Participants also reported their assessments of the rates to which key macroeconomic variables would be expected to converge in the longer run under appropriate monetary policy and in the absence of further shocks to the economy. The central tendencies of these longer-run projections were 2.5 to 2.8 percent for real GDP growth, 5.0 to 5.2 percent for the unemployment rate, and 1.7 to 2.0 percent for the inflation rate.

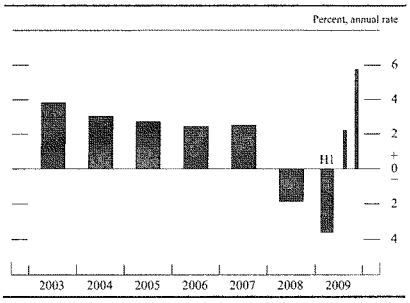
Part 2
Recent Financial and Economic Developments

According to the advance estimate from the Bureau of Economic Analysis, real gross domestic product (GDP) increased at an annual rate of 4 percent in the second half of 2009, retracing part of the sharp decline in activity that began in early 2008 (figure 1). Nonetheless, labor market conditions, which tend to lag changes in economic activity, remain very weak: The unemployment rate rose to 10 percent at the end of last year, 5 percentage points above its level at the start of 2008, before dropping back some in January. Conditions in many financial markets have improved significantly, but lending policies at banks remain stringent. Meanwhile, an increase in energy prices has boosted overall consumer price inflation; however, price inflation for other items has remained subdued, and inflation expectations have been relatively stable (figure 2).

Conditions in financial markets improved further in the second half of 2009, reflecting a more positive economic outlook as well as the effects of the policy initiatives implemented by the Federal Reserve, the Treasury, and other government agencies to support financial stability and promote economic recovery. Treasury yields, mortgage rates, and other market interest rates remained low while equity prices continued to rise, on net, amid positive earnings news, and corporate bond spreads narrowed substantially. As the functioning of short-term funding markets improved further, the usage of special liquidity facilities declined sharply, and the Federal Reserve closed several of those facilities on February 1, 2010.[1] Investors also seemed to become more optimistic about the prospects for the banking sector, and many of the largest banking institutions issued equity and repaid investments made by the Treasury under the Troubled Asset Relief Program (TARP). Nevertheless, the credit quality of bank loan portfolios remained a concern, particularly for loans secured by commercial and residential real estate loans.

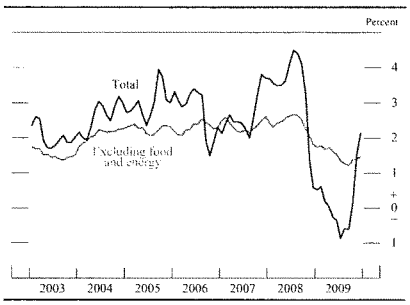
Private domestic nonfinancial sector debt contracted, on balance, in the second half of 2009. On the positive side, firms with access to capital markets issued corporate bonds at a robust pace, with many firms reportedly seeking to lock in long-term, low-interest-rate debt or refinance other debt. By contrast, many small businesses and other firms that depend primarily on banks for their funding needs faced substantial constraints on their access to credit even as demand for such credit remained weak. In the household sector, demand for

1. Change in real gross domestic product, 2003–09



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.

2. Change in the chain-type price index for personal consumption expenditures, 2003–09



NOTE: The data are monthly and extend through December 2009; changes are from one year earlier.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

1. Specifically, the Primary Dealer Credit Facility, the Term Securities Lending Facility, the Commercial Paper Funding Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and the temporary swap lines with foreign central banks were closed.

credit was weak, and supply conditions remained tight, as banks maintained stringent lending standards for both consumer loans and residential real estate loans. However, issuance of asset-backed securities (ABS), which are an important source of funding for consumer loans, strengthened, supported in part by the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF).

DOMESTIC DEVELOPMENTS

The Household Sector

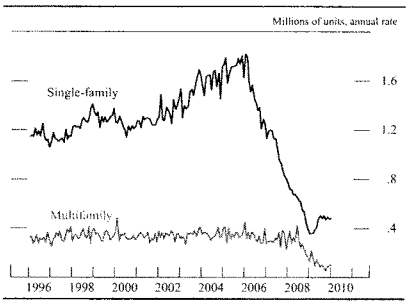
Residential Investment and Housing Finance

The housing market began to recover in the spring of 2009, but the pace of improvement slowed during the second half of the year. After having increased almost 30 percent through mid-2009, sales of new single-family homes retraced about one-half of that gain in the second half of the year. And, although sales of existing single-family homes moved up noticeably through November, they fell back sharply in December, suggesting that some of the earlier strength reflected sales that had been pulled forward in anticipation of the expiration of the first-time homebuyer tax credit.[2] The index of pending home sales, a leading indicator of sales of existing homes, leveled off in December after November's steep decline.

The recovery in construction activity in the single-family sector also decelerated in the second half of 2009. After stepping up noticeably last spring from an exceptionally low level, starts of single-family homes were about flat, on average, from June to December (figure 3). With the level of construction remaining quite low, the inventory of unsold new homes fell sharply and is now less than one-half of the peak reached in 2006. In the much smaller multifamily sector—where tight credit conditions and high vacancies have depressed building—starts deteriorated a bit further in the second half of the year.

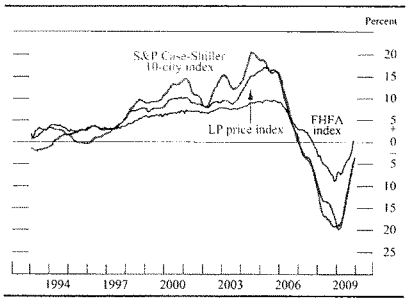
After falling sharply for about two and a half years, house prices, as measured by a number of national indexes, were more stable in the second half of 2009 (figure 4). One house price measure with wide geographic coverage—the LoanPerformance repeat-sales index—is up, on net, from its trough earlier in the year, even though the last few readings of that index fell back a bit. According to the Thomson Reuters/University of Michigan Surveys of Consumers, the number of respondents who expect house prices to increase over the next 12 months has moved up and now slightly exceeds the number of respondents who expect prices to decrease.[3]

3. Private housing starts, 1996–2010



NOTE: The data are monthly and extend through January 2010.
SOURCE: Department of Commerce, Bureau of the Census.

4. Change in prices of existing single-family houses, 1993–2009



NOTE: The data are monthly and extend into 2009:Q4; changes are from one year earlier. The LP price index includes purchase transactions only. The FHFA index (formerly calculated by the Office of Federal Housing Enterprise Oversight) also includes purchase transactions only. The S&P/Case-Shiller index reflects all arm's-length sales transactions in the metropolitan areas of Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco, and Washington, D.C.
SOURCE: For LP, LoanPerformance, a division of First American CoreLogic; for FHFA, Federal Housing Finance Agency; for S&P/Case-Shiller, Standard & Poor's.

2. The first-time homebuyer tax credit, which was enacted in February 2009 as part of the American Recovery and Reinvestment Act, was originally scheduled to expire on November 30, 2009. In early November, however, the Congress extended the credit to sales occurring through April 30, 2010, and expanded it to include repeat homebuyers who have owned and occupied a house for at least five of the past eight years.

3. The survey, formerly the Reuters/University of Michigan Surveys of Consumers, was renamed the Thomson Reuters/University of Michigan Surveys of Consumers as of January 1, 2010.

The earlier declines in house prices in combination with the low level of mortgage rates have made housing more affordable, and the apparent stabilization in prices may bring into the market buyers who were reluctant to purchase a home when prices were perceived to be falling. That said, the still-substantial inventory of unsold homes, including foreclosed homes, has continued to weigh on the market.

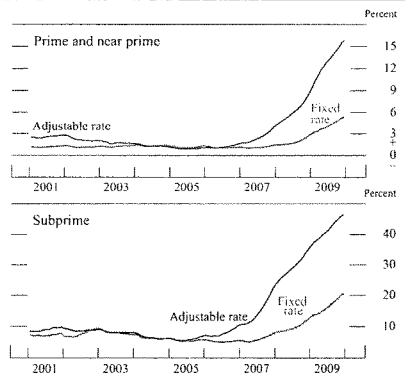
Even with house prices showing signs of stabilization, home values remained well below the remaining amount of principal on mortgages (so-called underwater loans) for many borrowers in the second half of 2009. Against this backdrop, and with a very high unemployment rate, delinquency rates on all types of residential mortgages continued to move higher (figure 5). As of December, serious delinquency rates on prime and near-prime loans had climbed to 16 percent for variable-rate loans and to over 5 percent for fixed rate loans.[4] The delinquency rate on all subprime loans was about 35 percent in December. Loans backed by the Federal Housing Administration (FHA) also showed increasing strains, with delinquency rates moving up to 9 percent at the end of 2009.

Foreclosures remained exceptionally elevated in the second half of 2009. About 1.4 million homes entered foreclosure during that period, similar to the pace earlier in the year. Historically, about one-half of foreclosure starts have resulted in homeowners losing the home. The heightened level of foreclosures has been particularly notable among prime borrowers, for whom the number of foreclosure starts moved up a bit in the second half of the year; by contrast foreclosure starts for subprime borrowers dropped back somewhat. To address the foreclosure problem, the Treasury has intensified efforts through its Making Home Affordable program to encourage loan modifications and to allow borrowers to refinance into mortgages with more-affordable payments.

Interest rates on 30-year fixed-rate conforming mortgages moved down in the second half of 2009, and despite a modest upturn around the start of 2010, they remained near the lowest levels on record (figure 6).[5] The low mortgage rates reflected the generally low level of Treasury yields and the large purchases of agency mortgage-backed securities (MBS) by the Federal Reserve, which were reportedly an important factor behind the narrow spread between these conforming mortgage rates and yields on Treasury securities. Interest rates on nonconforming mortgages, which are not included in the mortgage pools backing MBS that are eligible for purchase by the Federal Reserve,

4. A mortgage is defined as seriously delinquent if the borrower is 90 days or more behind in payments or the property is in foreclosure.

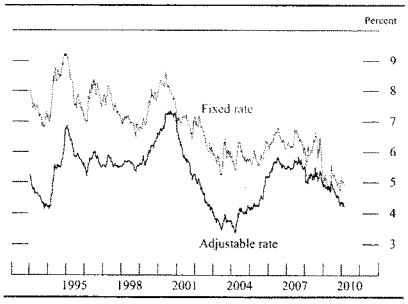
5. Mortgage delinquency rates, 2001–09



NOTE: The data are monthly and extend through December 2009. Delinquency rate is the percent of loans 90 days or more past due or in foreclosure.
SOURCE: For subprime, LoanPerformance, a division of First American CoreLogic; for prime and near prime, Lender Processing Services, Inc.

5. Conforming mortgages are those eligible for purchase by Fannie Mae and Freddie Mac; they must be equivalent in risk to a prime mortgage with an 80 percent loan-to-value ratio, and they cannot exceed in size the conforming loan limit. The conforming loan limit for a first mortgage on a single-family home in the contiguous United States is currently equal to the greater of $417,000 or 115 percent of the area's median house price, and it cannot exceed $729,750.

6. Mortgage interest rates, 1993–2010



NOTE: The data, which are weekly and extend through February 17, 2010, are contract rates on 30-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

also generally declined, but the spreads between nonconforming mortgage rates and rates on conforming mortgages remained wide by historical standards.

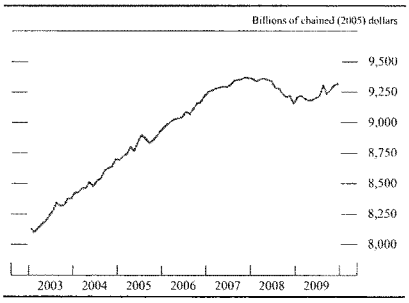
Although mortgage rates fell to low levels, the availability of mortgage financing continued to be sharply constrained. Respondents to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicated throughout 2009 that banks continued to tighten their lending standards for all types of mortgage loans, though smaller net fractions reported doing so in the January 2010 survey than had been the case in earlier surveys. Lenders' reluctance to extend mortgage credit in an environment of declining home values also likely held down refinancing activity, which remained subdued in the second half of 2009 even though mortgage rates decreased. The FHA announced that it was raising mortgage insurance premiums because its capital reserve ratio had fallen below the required threshold; at the same time, the FHA announced that it was increasing down-payment requirements for borrowers with very low credit scores. In recent years, the FHA has assumed a greater role in mortgage markets, especially for borrowers with high loan-to-value ratios or lower credit quality. Overall, residential mortgage debt outstanding contracted at an even faster pace in the second half than in the first half of the year. Net issuance of MBS by Fannie Mae, Freddie Mac, and Ginnie Mae, although brisk in the second half of 2009, was down a bit from the levels seen earlier in the year. The securitization market for mortgage loans not guaranteed by a housing-related government-sponsored enterprise (GSE) or the FHA remained closed.

Consumer Spending and Household Finance

After having been roughly constant in the first half of last year, real personal consumption expenditures (PCE) rose at an annual rate of about 2½ percent in the second half (figure 7). Sales of new light motor vehicles jumped from an average annual rate of 9½ million units in the first half of 2009 to a rate of 11¼ million units in the second half.[6] Part of this rebound likely reflected the "cash for clunkers" program, but even after the expiration of that program, sales remained close to 11 million units, supported in part by improved credit conditions for auto buyers as the ABS market revived. Real spending on goods excluding motor vehicles also increased at a robust pace in the second half of the year, while real outlays for services rose more modestly.

6. Sales dropped back in January, but the decline occurred largely at Toyota, which was confronted by widely publicized problems.

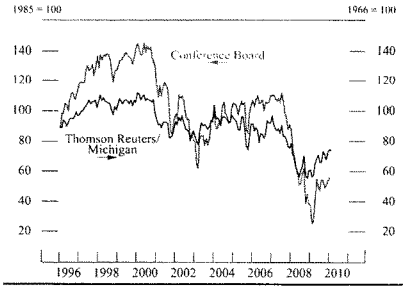
7. Real personal consumption expenditures, 2003–09



NOTE: The data are monthly and extend through December 2009.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

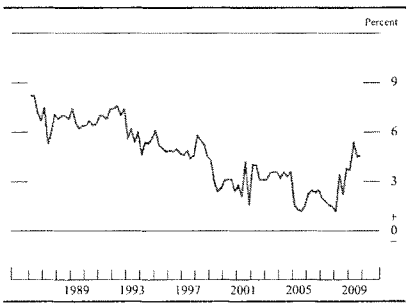
The rise in consumer spending in 2009 was buoyed by improvements in some of its underlying determinants: Equity prices moved up from their lows reached last March, a development that helped to rebuild household wealth, and household income was lifted by provisions in the fiscal stimulus package. Accordingly, consumer sentiment has rebounded from the very low levels seen earlier in 2009, though it remains low by historical standards (figure 8). Consumer spending appears to have been financed largely out of current income over the past year, and households were also able to increase their personal saving and begin

8. Consumer sentiment, 1996–2010



NOTE: The Conference Board data are monthly and extend through January 2010. The Thomson Reuters/Michigan data are monthly and extend through a preliminary estimate for February 2010; the survey in which the data are collected, formerly the Reuters/University of Michigan Surveys of Consumers, was renamed the Thomson Reuters/University of Michigan Surveys of Consumers as of January 1, 2010.
SOURCE: The Conference Board and Thomson Reuters/University of Michigan Surveys of Consumers.

9. Personal saving rate, 1986–2009



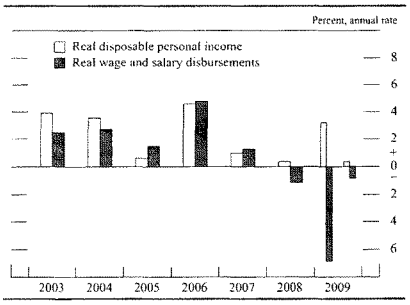
NOTE: The data are quarterly and extend through 2009:Q4.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

deleveraging their balance sheets. After increasing sharply in 2008, the saving rate moved up a bit further in 2009 (figure 9).

Real disposable personal income—after-tax income adjusted for inflation—increased about 1¾ percent last year, with the effects of the tax cuts and higher social benefit payments included in the 2009 fiscal stimulus package accounting for most of the increase.[7] Real labor income—that is, total wages, salaries, and employee benefits, adjusted for inflation—fell sharply in the first half of the 2009, and edged down a bit further in the second half, as the decline in total employee work hours more than offset an increase in real hourly compensation (figure 10).

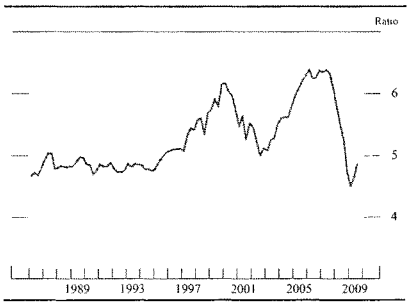
7. The increases in benefit payments under the American Recovery and Reinvestment Act included an expansion of unemployment benefits, increases in food stamps and Pell grants, subsidies for health insurance coverage for the unemployed, and a one-time $250 payment to retirees and veterans.

10. Change in real income and in real wage and salary disbursements, 2003–09



SOURCE: Department of Commerce, Bureau of Economic Analysis.

11. Wealth-to-income ratio, 1986–2009



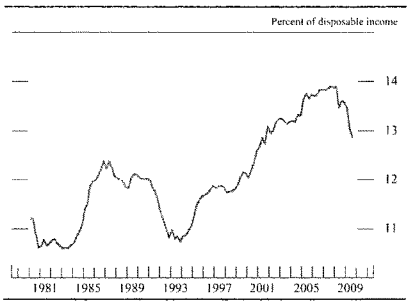
NOTE: The data are quarterly and extend through 2009:Q3. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

After dropping during the preceding 2½ years, household net worth turned up in the second and third quarters of 2009 and likely rose further in the fourth quarter. Much of the recovery reflected a rebound in equity prices, although the modest gain, on net, in the value of owner-occupied real estate also contributed. With the rise in net worth, the ratio of household wealth to disposable income increased in the second half of the year to about its historical average (figure 11).

Households began to deleverage around the third quarter of 2008, at the height of the financial crisis, and that process continued during the second half of 2009. The decline in nonmortgage consumer debt intensified during the latter part of last year. The contraction was most pronounced in revolving credit, which fell at about a 10 percent annual rate during the second half of 2009. Nonrevolving credit also decreased. Including the drop in mortgage debt, the Federal Reserve's flow of funds data indicate that total household debt declined in 2009 for the first time since the data series began in 1951. Reflecting these developments, debt service payments—the required principal and interest on existing mortgages and consumer debt—fell as a share of disposable income. At the end of the third quarter, the ratio of debt service payments to disposable income had declined to its lowest level since 2001 (figure 12).

Results from the recent SLOOS suggest that the contraction in consumer credit has been the result of both weak demand and tight supply. A net fraction of about one-third of the bank loan officers that responded to the

12. Household debt service, 1980–2009



NOTE: The data are quarterly and extend through 2009:Q3. Debt service payments consist of estimated required payments on outstanding mortgage and consumer debt.
SOURCE: Federal Reserve Board, "Household Debt Service and Financial Obligations Ratios," statistical release.

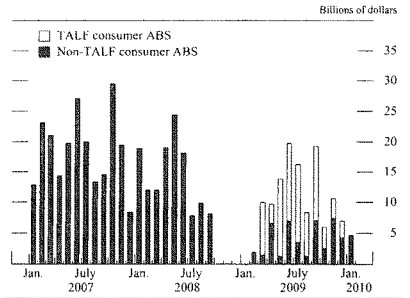
January SLOOS reported weaker demand for all types of consumer loans. The same survey also indicated that banks continued to tighten terms on credit card loans over the final three months of 2009 by reducing credit limits and raising interest rates charged, though smaller net fractions reported doing so than in previous surveys. After having been tightened significantly in the summer and fall of 2009, standards and terms on consumer loans other than credit card loans were little changed, on balance, in the January survey.

Changes in interest rates on consumer loans were mixed during the second half of 2009. Interest rates on new auto loans generally continued to trend lower, and spreads on these loans relative to comparable-maturity Treasury securities narrowed further. Interest rates on credit card loans, however, jumped near midyear and increased further toward year-end. According to the October SLOOS, some of the increases in credit card interest rates and the tightening of other lending terms reflected adjustments made by banks in anticipation of the imposition of new rules under the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act.[8]

Concerns about the ability of households to repay loans may also have contributed to the tightening of lending policies for consumer credit over the second half of 2009. Delinquency rates on auto loans at captive finance companies remained elevated, and credit card delinquency rates at commercial banks stayed high at around 6½ percent in the fourth quarter of 2009. In addition, the pace at which lenders were charging off these loans increased sharply in recent quarters. On a more positive note, respondents to the January SLOOS indicated that they expected the credit quality of their consumer loans, other than credit card loans, to stabilize during 2010.

Prior to the crisis, a large portion of consumer credit was funded through the ABS market. After having essentially ground to a halt at the end of 2008, consumer ABS markets recovered in 2009 with the important support of the TALF (figure 13). Much of the ABS issuance through the summer relied heavily on the TALF for financing. By the end of the year, the yields on such securities dropped markedly, and issuance of ABS without TALF support increased accordingly. (Indeed, the interest rates on TALF loans were chosen so that they would become unattractive as market conditions improved.) Issuance of ABS backed by auto loans in the second half of 2009 was roughly on par with issuance prior to the financial crisis, and only a small portion was purchased using loans from the TALF. A renewed ability to securitize auto loans may have contributed to the reduction in the interest rates on these loans. Similarly, ABS issuance backed by credit card receivables gained strength through most of the year, though it experienced a drop early in the fourth quarter because of uncertainty about how the Federal Deposit Insurance Corporation (FDIC) would treat securitized receivables should a sponsoring bank fail. Issuance picked up slightly after

13. Gross issuance of selected asset-backed securities, 2007–10



NOTE: Consumer ABS (asset-backed securities) are securities backed by credit card loans, nonrevolving consumer loans, and auto loans. Data for consumer ABS show gross issuance facilitated by the Term Asset-Backed Securities Loan Facility (TALF) and such issuance outside the TALF.
SOURCE: Bloomberg and the Federal Reserve Bank of New York.

8. The Credit CARD Act includes some provisions that place restrictions on issuers' ability to impose certain fees and to engage in risk-based pricing. Some provisions took effect in August 2009, and others did so in February 2010.

the FDIC provided a temporary extension of safe-harbor rules for its handling of securitized assets in a receivership. By contrast, issuance of ABS backed by private student loans remained almost entirely dependent on financing from the TALF.

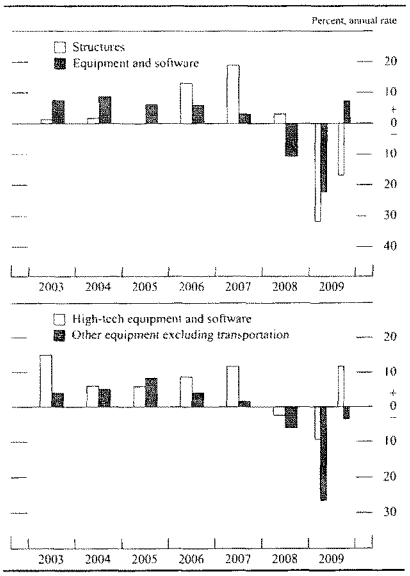
The Business Sector

Fixed Investment

After falling throughout 2008 and the first half of 2009, business spending on equipment and software (E&S) began to expand in the second half of last year, as sales prospects picked up, corporate profits increased, and financial conditions for many businesses (especially those with direct access to capital markets) improved (figure 14). Business outlays on transportation equipment rose sharply in the second half as firms rebuilt their fleets of light motor vehicles and accelerated their purchases of large trucks in advance of new environmental regulations on diesel engines. Real spending on information technology capital—computers, software, and communications equipment—also accelerated toward the end of 2009, likely boosted by the desire to replace older, less-efficient equipment. Investment in equipment other than information processing and transportation, which accounts for nearly one-half of E&S outlays, continued to fall during the second half of 2009, but much more slowly than earlier in the year. More recently, orders of nondefense capital goods other than transportation items posted a second strong monthly increase in December, and recent surveys of business conditions have been more upbeat than in several years.

In contrast to the upturn in equipment investment, real spending on nonresidential structures continued to decline steeply throughout 2009. Real outlays for construction of structures other than those used for drilling and mining fell at an annual rate of 25 percent in the second half of 2009, likely reflecting the drag from rising vacancy rates and plunging property prices for commercial and office buildings, as well as difficult financing conditions for new projects. Following a steep drop in the first half of the year, real spending on drilling and mining structures increased sharply in the second half, likely in response to the rebound in oil prices.

14. Change in real business fixed investment, 2003–09

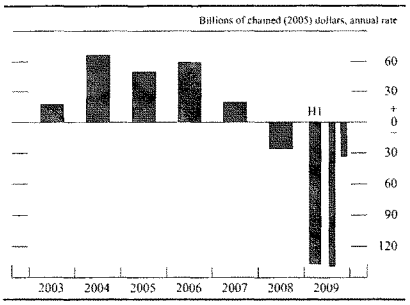


NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Inventory Investment

After running off inventories aggressively during the first three quarters of 2009, firms moved to stem the pace of liquidation in the fourth quarter (figure 15). Automakers added to their dealers' stocks after cutbacks in production earlier in the year had reduced

15. Change in real business inventories, 2003–09



SOURCE: Department of Commerce, Bureau of Economic Analysis.

days' supply of domestic light vehicles to below their preferred levels. Outside of motor vehicles, firms continued to draw down inventories in the fourth quarter, but at a much slower pace than earlier in the year. Indeed, purchasing managers in the manufacturing sector report that their customers' inventories are relatively lean, a development that could lead to some restocking in the coming months.

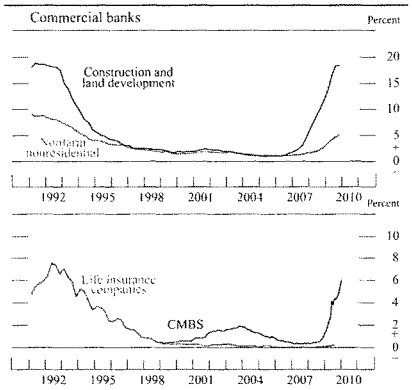
Corporate Profits and Business Finance

Overall, operating earnings per share for S&P 500 firms rebounded over the course of 2009. Still, earnings were well below the levels experienced prior to the financial market turmoil and the accompanying recession. Within the S&P 500, earnings for financial firms fluctuated around low levels, while earnings for nonfinancial firms rebounded sharply as the economic recovery began to take hold. Data from firms that have reported for the fourth quarter suggest that earnings for nonfinancial firms continued to recover.

The credit quality of nonfinancial corporations improved somewhat over the second part of last year, although signs of stress persisted. Business leverage, as measured by the ratio of debt to assets, fell in the third quarter. Credit rating downgrades outpaced upgrades early in 2009, but the pace of downgrades moderated substantially in the second half of the year, and by the fourth quarter upgrades were outpacing downgrades. In addition, the corporate bond default rate dropped into the range that had prevailed before the financial crisis began in August 2007.

Delinquency rates on loans to nonfinancial businesses, however, rose throughout the year. For commercial and industrial (C&I) loans, delinquencies in the fourth quarter reached 4.5 percent. In response to a special question on the January 2010 SLOOS, a large net fraction of banks reported that in the fourth quarter, the credit quality of their existing C&I loans to small firms was worse than the quality of their loans to larger firms. While survey respondents generally expected the credit quality of their C&I loan portfolios to improve during 2010, banks' outlook for C&I loans to larger firms was more optimistic than it was for such loans to smaller firms. Reflecting deterioration in commercial property markets, delinquency rates on commercial real estate (CRE) loans both in securitized pools and on banks' books moved up sharply in the second half of 2009 (figure 16). Delinquency rates on construction and land development loans climbed to especially high levels. In October 2009, the Federal Reserve joined with other banking regulators to provide guidelines to banks in

16. Delinquency rates on commercial real estate loans, 1991–2010



NOTE: The data for commercial banks and life insurance companies are quarterly and extend through 2009:Q4 and 2009:Q3, respectively. The data for commercial mortgage-backed securities (CMBS) are monthly and extend through January 2010. The delinquency rates for commercial banks and CMBS are the percent of loans 30 days or more past due or not accruing interest. The delinquency rate for life insurance companies is the percent of loans 60 days or more past due or not accruing interest.

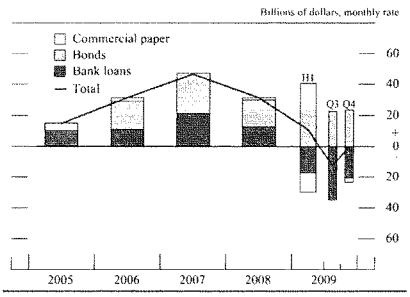
SOURCE: For commercial banks, Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report); for life insurance companies, American Council of Life Insurers; for CMBS, Citigroup.

their efforts to work constructively with troubled CRE borrowers.[9]

The debt of domestic nonfinancial businesses contracted slightly during the second half of 2009, and the composition of borrowing continued to shift toward longer-term debt (figure 17). Net issuance of corporate bonds remained strong as businesses took advantage of favorable market conditions to issue longer-term debt; at the same time, bank loans to businesses—both C&I and CRE loans—contracted, as did commercial paper.

9. This statement updated and replaced existing supervisory guidance to assist examiners in evaluating institutions' efforts to renew or restructure loans to creditworthy CRE borrowers. The statement was intended to promote supervisory consistency, enhance the transparency of CRE workout transactions (that is, transactions intended to renew and restructure the loans), and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. For more information, see Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Financial Institutions Examination Council State Liaison Committee (2009), "Policy Statement on Prudent Commercial Real Estate Loan Workouts," attachment to Supervision and Regulation Letter SR 09-7 (October 30), www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf.

17. Selected components of net financing for nonfinancial businesses, 2005–09



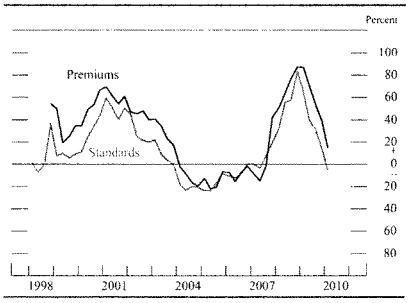
NOTE: The data for the components except bonds are seasonally adjusted.
SOURCE: Federal Reserve Board, flow of funds data.

The decline in bank lending to businesses was due partly to the weakness in loan demand. Many banks experiencing steep declines in C&I loans reported that existing loans were paid down across a wide swath of industries. Respondents to the January 2010 SLOOS indicated that weak demand for C&I loans during the second half of 2009 reflected their customers' reduced need to use these loans to finance investment in plant and equipment as well as to finance accounts receivable, inventories, and mergers and acquisitions. In addition, demand was reportedly low for CRE loans amid weak fundamentals in the sector.

The weakness in bank lending to businesses in 2009 was also a consequence of a tightening in lending standards. Responses to the SLOOS indicated that lending standards for C&I loans were tightened significantly in the summer and fall of 2009 and that they remained about unchanged in the final months of the year (figure 18). In addition, many banks continued to tighten some terms throughout the year—for example, by increasing the interest rate premiums charged on riskier loans. Considerable net fractions of banks also continued to report tightening lending standards on CRE loans.

Small businesses have been particularly affected by tight bank lending standards because of their lack of direct access to capital markets. In surveys conducted by the National Federation of Independent Business (NFIB), the net fraction of small businesses reporting that credit had become more difficult to obtain over the preceding three months remained at extremely elevated levels during the second half of 2009 (figure 19). Moreover, considerable net fractions of NFIB survey respondents expected lending conditions to tighten further in

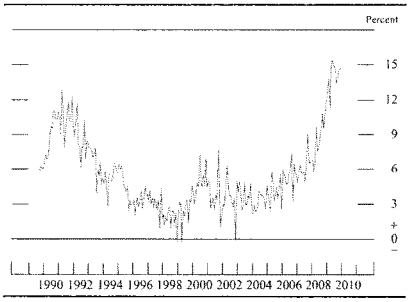
18. Net percentage of domestic banks tightening standards and increasing premiums charged on riskier loans to large and medium-sized borrowers, 1998–2010



NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is from the January 2010 survey, which covers 2009:Q4. Net percentage is the percentage of banks reporting a tightening of standards or an increase in premiums less the percentage reporting an easing or a decrease. The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have annual sales of $50 million or more.
SOURCE: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices.

the near term. However, when asked about the most important problem they faced, small businesses most frequently cited poor sales, while only a small fraction cited credit availability. Recognizing that small businesses play a crucial role in the economy and that some are experiencing difficulty in obtaining or renewing credit, the federal financial regulatory agencies and the

19. Net percentage of small businesses that reported more difficulty in obtaining credit, 1989–2010



NOTE: The data are drawn from a survey conducted monthly and are seasonally adjusted; the last observation is from the January 2010 survey, which covers December 2009. The data reflect the proportion of borrowers who sought credit in the past three months that reported more difficulty in obtaining credit less the proportion that reported more ease in obtaining credit.
SOURCE: National Federation of Independent Business.

Conference of State Bank Supervisors issued a statement on February 5, 2010, regarding lending to these businesses.[10] The statement emphasized that financial institutions that engage in prudent small business lending will not be subject to supervisory criticism for small business loans made on that basis. Further, the statement emphasized that regulators are working with the industry and supervisory staff to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to financially sound small business borrowers.

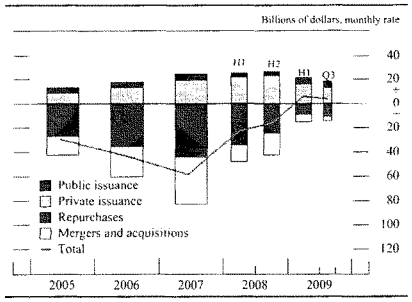
In the equity market, both seasoned and initial offerings by nonfinancial firms were solid in the second half of 2009 (figure 20). After nearly ceasing earlier in the year, cash-financed mergers picked up toward year-end, mostly as the result of a few large deals. Share repurchases continued to be light.

New issuance in the commercial mortgage-backed securities (CMBS) market—which had ceased in the third quarter of 2008, thus eliminating an important source of financing for many lenders—resumed in November 2009 with a securitization supported by the Federal Reserve's TALF program. A handful of subsequent small securitizations, with more-conservative underwriting and simpler structures than had prevailed during the credit boom, were brought to market and successfully completed without support from the TALF. Nevertheless, issuance of CMBS remains very light, and material increases in issuance appeared unlikely in the near term. Trading in existing CMBS picked up during the second half of 2009, and yield spreads relative to Treasury securities narrowed, although they remain very high by historical standards. Some of the improvement likely reflected support provided by the Federal Reserve through the part of the TALF program that provides loans for the purchase of "legacy" CMBS.

Issuance of leveraged loans, which often involves loan extensions by nonbank financial institutions, also remained weak throughout 2009 although market conditions reportedly improved. Prior to the crisis, this segment of the syndicated loan market provided considerable financing to lower-rated nonfinancial firms. However, issuance of leveraged loans fell to low levels when investors moved away from structured finance products such as collateralized loan obligations, which had been substantial purchasers of such credits. The market began to show signs of recovery last year with secondary-market prices of loans moving higher, and, by late in the year, new loans had found increased investor interest amid some easing in loan terms.

10. For more information, see Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, National Credit Union Administration, and Conference of State Bank Supervisors (2010), "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers," attachment to "Regulators Issue Statement on Lending to Creditworthy Small Businesses," joint press release, February 5, www.occ.treas.gov/ftp/release/2010-14.htm.

20. Components of net equity issuance, 2005–09



NOTE: Net equity issuance is the difference between equity issued by domestic companies in public or private markets and equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.

SOURCE: Thomson Financial, Investment Benchmark Report; Money Tree Report by PricewaterhouseCoopers, National Venture Capital Association, and Venture Economics.

The Government Sector

Federal Government

The deficit in the federal unified budget rose markedly in fiscal year 2009 and reached $1.4 trillion, about $1 trillion higher than in fiscal 2008. The effects of the weak economy on revenues and outlays, along with the budget costs associated with the fiscal stimulus legislation enacted last February (the American Recovery and Reinvestment Act (ARRA)), the Troubled Asset Relief Program, and the conservatorship of the mortgage-related GSEs, all contributed to the widening of the budget gap. The deficit is expected to remain sharply elevated in fiscal 2010. Although the budget costs of the financial stabilization programs are expected to be lower than in the last fiscal year, the spend-out from last year's fiscal stimulus package is expected to be higher, and tax revenues are anticipated to remain weak. The Congressional Budget Office projects that the deficit will be about $1.3 trillion this fiscal year, just a touch below last year's deficit, and that federal debt held by the public will reach 60 percent of nominal GDP, the highest level recorded since the early 1950s.

The steep drop in economic activity during 2008 and the first half of 2009 resulted in sharply lower tax receipts (figure 21). After falling about 2 percent in fiscal 2008, federal receipts plunged 18 percent in fiscal 2009, and tax receipts over the first four months of the current fiscal year have continued to decline relative to the comparable year-earlier period. The decline in revenues in fiscal 2009 was particularly steep for corporate taxes, mostly as a result of the sharp contraction in corporate profits in 2008.[11] Individual income and payroll taxes also declined substantially, reflecting the effects of the weak labor market on nominal wage and salary income, a decline in capital gains realizations, and the revenue-reducing provisions of the 2009 fiscal stimulus legislation.

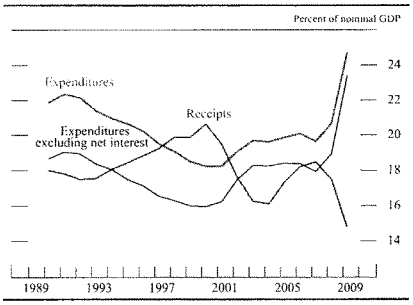
While the outlays associated with the TARP and the conservatorship of the GSEs contributed importantly to the rapid rise in federal spending in fiscal 2009, outlays excluding these extraordinary costs rose a relatively steep 10 percent.[12] Spending for Medicaid and income support programs jumped almost 25 percent in fiscal 2009 as a result of the deterioration in the labor market as well as policy decisions to expand funding for a number of such programs. This category of spending has continued to rise rapidly thus far in fiscal 2010, and most other categories of spending have increased fairly briskly as well.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of GDP—rose at a 4 percent pace in the second half of 2009 (figure 22). Nondefense outlays increased rapidly, in part reflecting the boost in spending from the 2009 fiscal stimulus legislation, while real defense outlays rose modestly.

11. Because final payments on 2008 liabilities were not due until April of 2009 and because of the difference between fiscal and calendar years, much of the contraction in 2008 corporate profits did not show through to tax revenues until fiscal 2009.

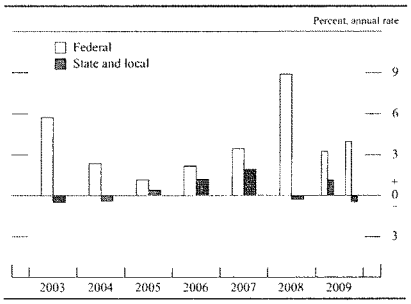
12. In the Monthly Treasury Statements, equity purchases and debt-related transactions under the TARP are recorded on a net present value basis, taking into account market risk, as are the Treasury's purchases of the GSE's MBS. However, equity purchases from the GSEs in conservatorship are recorded on a cash flow basis.

21. Federal receipts and expenditures, 1989–2009



NOTE: The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); gross domestic product (GDP) is for the four quarters ending in Q3.
SOURCE: Office of Management and Budget.

22. Change in real government expenditures on consumption and investment, 2003–09



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal Borrowing

Federal debt expanded rapidly throughout 2009 and rose to more than 50 percent of nominal GDP by the end of 2009, up from around 35 percent earlier in the decade. To fund the increased borrowing needs, Treasury auctions grew to record sizes. However, demand for Treasury issues kept pace, and bid-to-cover ratios at these auctions were generally strong. Foreign demand was solid, and foreign custody holdings of Treasury securities at the Federal Reserve Bank of New York increased considerably over the year.

State and Local Government

Despite the substantial federal aid provided by the ARRA, the fiscal situations of state and local governments remain challenging. At the state level, revenues from income, business, and sales taxes continued to

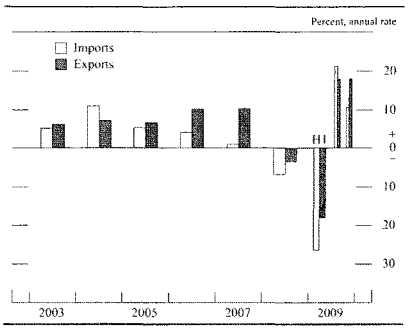
fall in the second half of last year, and many states are currently in the process of addressing shortfalls in their fiscal 2010 budgets. At the local level, revenues have held up fairly well, as receipts from property taxes, on which these jurisdictions rely heavily, have continued to rise moderately, reflecting the typically slow response of property assessments to changes in home values. Nevertheless, the sharp fall in house prices over the past few years is likely to put some downward pressure on local revenues before long. Moreover, many state and local governments have experienced significant capital losses in their employee pension funds, and they will need to set aside resources in coming years to rebuild pension assets.

These budget pressures showed through to state and local spending. As measured in the NIPA, real consumption expenditures of state and local governments declined over the second half of 2009.[13] In particular, these jurisdictions began to reduce employment in mid-2009, and those cuts continued in January. In contrast, investment spending by state and local governments rose moderately during the second half of 2009. The rise in investment spending was supported by infrastructure grants provided by the federal government as part of the ARRA, as well as by a recovery of activity in municipal bond markets that increased the availability and lowered the cost of financing. Also, because capital budgets are typically not encompassed within balanced budget requirements, states were under less pressure to restrain their investment spending.

State and Local Government Borrowing

Borrowing by state and local governments picked up a bit in the second half of the year from its already solid pace in the first half. Gross issuance of long-term bonds, primarily to finance new capital projects, was strong. Issuance was supported by the Build America Bonds program, which was authorized under the ARRA.[14] Short-term issuance was more moderate and generally consistent with typical seasonal patterns. Market participants reported that the market for variable-rate demand obligations, which became severely strained during the financial crisis, had largely recovered.[15]

23. Change in real imports and exports of goods and services, 2003–09



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Interest rates on long-term municipal bonds declined during the year, but the ratio of their yields to those on comparable-maturity Treasury securities remained somewhat elevated by historical standards. Credit ratings of state and local governments deteriorated over 2009 as a consequence of budgetary problems faced by many of these governments.

The External Sector

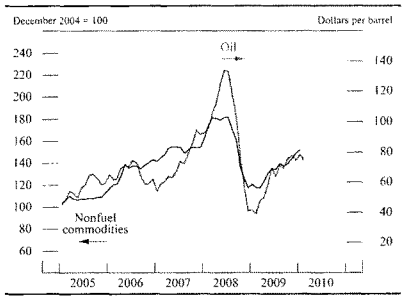
Both exports and imports rebounded in the second half of 2009 from precipitous falls earlier in the year (figure 23). As foreign economic activity began to improve, real exports rose at an annual rate of nearly 20 percent in the second half of the year. Real imports increased at about the same pace, supported by the recovery under way in U.S. demand. The pickup in trade flows was widespread across major types of products and U.S. trading partners but was particularly pronounced for both exports and imports of capital goods. Exports and imports of automotive products also picked up sharply in the second half of last year, reflecting the rise in motor vehicle production in North America, which depends importantly on flows of parts and finished vehicles between the United States, Canada, and Mexico. Despite the bounceback, trade flows only par-

13. Consumption expenditures by state and local governments include all outlays other than those associated with investment projects.

14. The Build America Bonds program allows state and local governments to issue taxable bonds for capital projects and receive a subsidy payment from the Treasury for 35 percent of interest costs.

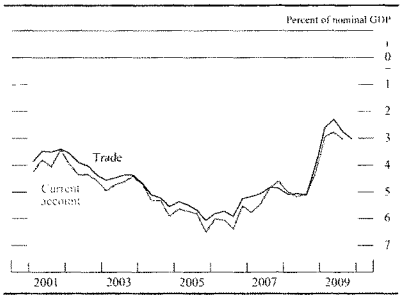
15. Variable-rate demand obligations (VRDOs) are taxable or tax-exempt bonds that combine long maturities with floating short-term interest rates that are reset on a weekly, monthly, or other periodic basis. VRDOs also have a contractual liquidity backstop, typically provided by a commercial or investment bank, that ensures that bondholders are able to redeem their investment at par plus accrued interest even if the securities cannot be successfully remarketed to other investors.

24. Prices of oil and nonfuel commodities, 2005–10



NOTE: The data are monthly. The oil price is the spot price of West Texas Intermediate crude oil, and the last observation is the average for February 1–17, 2010. The price of nonfuel commodities is an index of 45 primary-commodity prices and extends through January 2010.
SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

25. U.S. trade and current account balances, 2001–09



NOTE: The data are quarterly. For the trade account, the data extend through 2009:Q4; for the current account, they extend through 2009:Q3.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

tially retraced the unusually steep declines registered in late 2008 and early 2009. This pattern was also true for global trade flows, as discussed in the box "Developments in Global Trade." The strength of the recovery in global trade so far, however, differs substantially across countries and regions.

Oil and nonfuel commodity prices increased substantially over the year (figure 24). After plunging from a daily high of about $145 per barrel in mid-2008 to a low of less than $40 per barrel early in 2009, the spot price of West Texas Intermediate crude oil rose rapidly to reach about $70 per barrel by the middle of 2009. The price of oil rose further over the second half of the year to reach about $80 per barrel in November and has fluctuated between $70 and $80 per barrel through mid-February 2010. The increase in the price of oil over the course of 2009 was driven in large measure by strengthening global activity, particularly in the emerging market economies. The ongoing effects of earlier restrictions in OPEC supply were another likely contributing factor. The prices of longer-term futures contracts (that is, those expiring in December 2018) for crude oil also moved up and, as of mid-February, were about $96 per barrel. The upward-sloping futures curve is consistent with a view by market participants that oil prices will continue to rise as global demand strengthens over the medium term.

Broad indexes of nonfuel commodity prices also rose from lows near the start of 2009. As with the rise in oil prices, a key driver of the increase in commodity prices has been resurgent demand from emerging market economies, especially China. Market participants expect some further increases in commodity prices as the economic recovery gains strength, albeit increases that are less pronounced than those recorded during last year's rebound.

The steep decline in commodity prices in late 2008 put considerable downward pressure on U.S. import prices for the first half of 2009. Overall for 2009, prices of imported goods fell 1 percent while prices for goods excluding oil fell 2½ percent. Recent upward moves in commodity prices suggest that some of this downward pressure on import prices will be reversed in 2010.

The U.S. trade deficit narrowed considerably in the first half of 2009. Nominal imports fell more than nominal exports early in the year, partly reflecting a substantial decline in the value of oil imports. The trade deficit widened moderately over the remainder of the year, however, as both imports and exports picked up in subsequent quarters and oil prices moved higher. In the fourth quarter of 2009, the trade deficit was $440 billion (annual rate), or about 3 percent of nominal GDP, compared with a deficit of 4 percent of nominal GDP a year earlier (figure 25).

National Saving

Total U.S. net national saving—that is, the saving of households, businesses, and governments, excluding depreciation charges—remained extremely low by historical standards in 2009, averaging about negative 2½ percent of nominal GDP over the first three quarters of the year (figure 26). After having reached nearly 4 percent of nominal GDP in early 2006, net national saving dropped over the subsequent three years as the federal budget deficit widened substantially and the

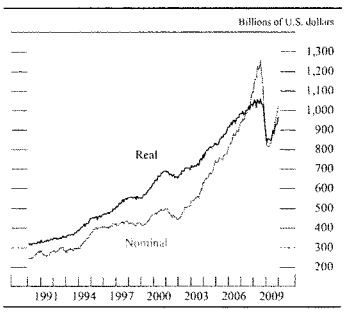
Developments in Global Trade

The downturn in global activity was accompanied by a dramatic collapse in global trade. Measured in U.S. dollars, global exports fell about 35 percent between July 2008 and February 2009.[1] About one-third of the decline was a result of falling prices, notably for oil and other commodities. The volume of global exports is estimated to have contracted about 20 percent between mid-2008 and early 2009, a larger and more abrupt decline than has been observed in previous cycles (figure A).

The fall in global exports was also more widespread across countries and regions than has typically been the case in past recessions. The severity of the decline in trade was a major factor in the spread of the economic downturn to the emerging market economies in Asia and Latin America, which were generally less directly exposed to the financial crisis than were the advanced economies. Early on, financial and economic indicators in the emerging market economies appeared to be relatively resilient, raising the possibility that those economies had "decoupled" from developments in the advanced economies. However, the trade channel proved quite potent, and most of the emerging market economies experienced deep recessions. A major exception was China, which provided considerable fiscal stimulus to its own economy.

1. The total includes 44 countries. The emerging Asian economies consist of China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand, and Vietnam; the Latin American economies consist of Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela; the other emerging market economies consist of Hungary, Israel, Poland, Russia, South Africa, and Turkey; and the advanced economies consist of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

A. Real and nominal global exports, 1990–2009



NOTE: The data are monthly and extend through December 2009. Real global exports are staff estimates expressed in billions of 2007 U.S. dollars.

SOURCE: The nominal data are the sum of U.S. dollar exports from individual country sources via databases maintained by Haver Analytics, CEIC, and the IMF Direction of Trade Statistics, in some cases seasonally adjusted by Federal Reserve staff. Forty-four countries are included. The real data are calculated using trade prices from country sources via Haver Analytics (in some cases interpolated from quarterly or annual data), which are converted to U.S. dollar prices using each country's dollar exchange rate and rebased to 2007.

The primary explanation for the deep and abrupt collapse in global trade seems to be that the contraction in global demand was much more severe than in the past. Constraints on the supply of trade finance related to the general credit crunch may have played a role at the beginning, but the fall in demand soon became the more important factor. The sensitivity of trade to the decline in gross domestic product also appears to have been stronger in this cycle than in past cycles, although there is no real agreement on why this might be the case. Greater integration of production across coun-

fiscal positions of state and local governments deteriorated. In contrast, private saving rose considerably, on balance, over this period. National saving will likely remain relatively low this year in light of the continuing high federal budget deficit. If not raised over the longer run, persistent low levels of national saving will likely be associated with both low rates of capital formation and heavy borrowing from abroad, limiting the rise in the standard of living of U.S. residents over time.

The Labor Market

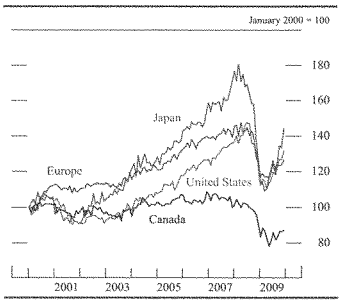
Employment and Unemployment

After falling sharply in the first half of 2009, employment continued to contract through the remainder of the year, but at a gradually moderating pace. Nonfarm private payroll employment fell 725,000 jobs per month, on average, from January to April of 2009; the pace of

tries and an increase in exports of products for which there are shorter lags between changes in demand and changes in exports—such as electronics—may also have added to the speed and synchronicity of the collapse.

Exports appear to have stopped declining in most economies in the first half of 2009, but so far the strength of the recovery in trade has differed across countries. In particular, exports of the emerging Asian economies are much closer to their previous peaks than are exports of the advanced economies (figures B and C), as the strength of the Chinese economy has so far been a key factor driving exports of the other emerging Asian economies.

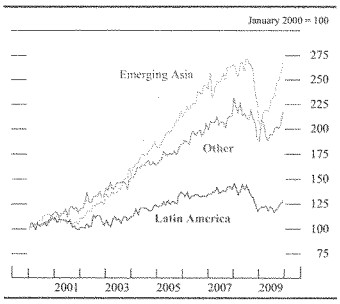
B. Real export indexes for advanced economies, 2000–09



NOTE: The data are monthly and extend through December 2009. In this figure, the European economies are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

SOURCE: The nominal data are U.S. dollar exports from individual country sources via databases maintained by Haver Analytics and the IMF Direction of Trade Statistics, in some cases seasonally adjusted by Federal Reserve staff. The real data are calculated using trade prices from country sources via Haver Analytics (in some cases interpolated from quarterly or annual data), which are converted to U.S. dollar prices using each country's dollar exchange rate and rebased to 2007.

C. Real export indexes for emerging market economies, 2000–09



NOTE: The data are monthly and extend through December 2009. In this figure, the emerging Asian economies are China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand, and Vietnam; the Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela; and the other economies are Hungary, Israel, Poland, Russia, South Africa, and Turkey.

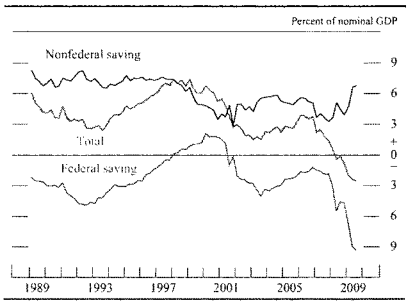
SOURCE: The nominal data are U.S. dollar exports from individual country sources via databases maintained by Haver Analytics, CEIC, and the IMF Direction of Trade Statistics, in some cases seasonally adjusted by Federal Reserve staff. The real data are calculated using trade prices from country sources via Haver Analytics (in some cases interpolated from quarterly or annual data), which are converted to U.S. dollar prices using each country's dollar exchange rate and rebased to 2007.

job loss slowed to about 300,000 per month from May to October, and to an average of 20,000 jobs per month from November to January (figure 27). The moderation in the pace of job losses was relatively widespread across sectors, although cutbacks in employment in the construction industry continued to be sizable through January.

After rising rapidly for more than a year, the unemployment rate stabilized at 10 percent in the fourth quarter of 2009 (figure 28). In January, the jobless rate dropped to 9.7 percent, though it remained 4.7 percentage points higher than its level two years ago.

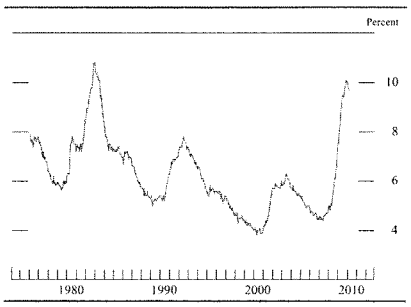
The slowing in net job losses since mid-2009 primarily reflected a reduction in layoffs rather than an improvement in hiring. Both the number of new job losses and initial claims for unemployment insurance are down significantly from their highs in the spring of 2009, while most indicators of hiring conditions, such

26. Net saving, 1989–2009



NOTE: The data are quarterly and extend through 2009:Q3. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments. GDP is gross domestic product.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

28. Civilian unemployment rate, 1976–2010

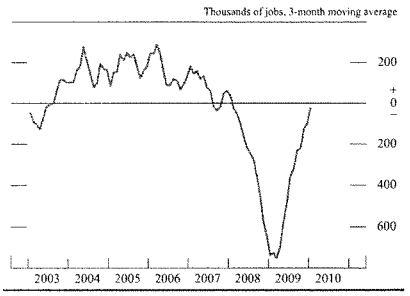


NOTE: The data are monthly and extend through January 2010.
SOURCE: Department of Labor, Bureau of Labor Statistics.

as the Bureau of Labor Statistics survey of job openings, remain weak. The average duration of an ongoing spell of unemployment continued to lengthen markedly in the second half of 2009, and joblessness became increasingly concentrated among the long-term unemployed. In January, 6.3 million individuals—more than 40 percent of the unemployed—had been out of work for at least six months. Furthermore, the labor force participation rate has declined steeply since last spring, a development likely related, at least in part, to the reactions of potential workers to the scarcity of employment opportunities (figure 29).

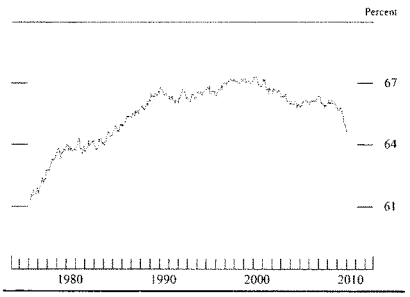
However, in recent months, labor market reports have included some encouraging signs that labor demand may be firming. For example, employment in the temporary help industry, which frequently is one of the first to see an improvement in hiring, has been increasing since October. In addition, after steep declines in 2008 and the first quarter of 2009, the average workweek of production and nonsupervisory employees stabilized at roughly 33.1 hours per week through the remainder of the year, before ticking up to 33.2 hours in November and December and 33.3 hours in January. Another indicator of an improvement in work hours, the fraction of workers on part-time schedules for economic reasons, increased only slightly, on net, in the second half of the year after a sharp rise in the first half and then turned down noticeably in January.

27. Net change in private payroll employment, 2003–10



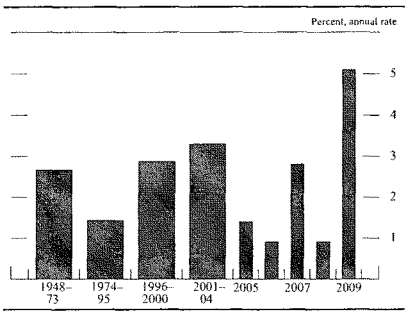
NOTE: The data are monthly and extend through January 2010.
SOURCE: Department of Labor, Bureau of Labor Statistics.

29. Labor force participation rate, 1976–2010



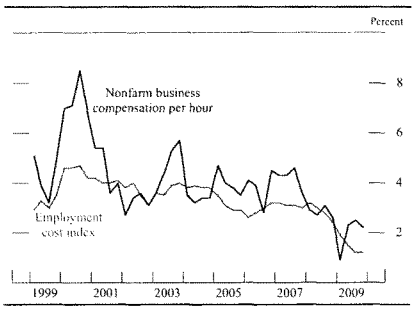
NOTE: The data are monthly and extend through January 2010.
SOURCE: Department of Labor, Bureau of Labor Statistics.

30. Change in output per hour, 1948–2009



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

31. Measures of change in hourly compensation, 1999–2009



NOTE: The data are quarterly and extend through 2009:Q4. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the 12 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 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.

Productivity and Labor Compensation

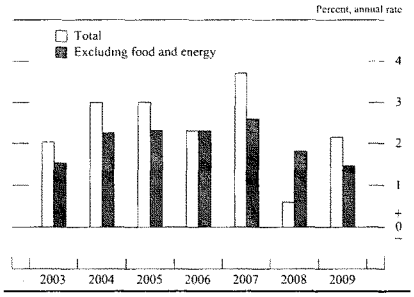
Labor productivity surged in 2009, reflecting, at least to some extent, the reluctance of firms to increase hiring even as demand expanded. According to the latest available published data, output per hour in the nonfarm business sector increased at an annual rate of 6¾ percent in the second half of 2009, after rising 3½ percent in the first half, and about 1 percent in 2008 (figure 30).

Despite large gains in productivity, increases in hourly worker compensation have remained subdued. The employment cost index for private industry workers, which measures both wages and the cost to employers of providing benefits, rose only 1¼ percent in nominal terms in 2009 after rising almost 2½ percent in 2008. Compensation per hour in the nonfarm business sector—a measure derived from the worker compensation data in the NIPA—showed less deceleration, rising 2.2 percent in nominal terms in 2009, only slightly slower than the 2.6 percent rise recorded for 2008 (figure 31). Real hourly compensation—that is, adjusted for the rise in consumer prices—increased only modestly. Reflecting the subdued increase in nominal hourly compensation, along with the outsized gain in labor productivity noted earlier, unit labor costs in the nonfarm business sector declined 2¾ percent in 2009.

Prices

Headline consumer price inflation picked up in 2009, as sharp increases in energy prices offset reductions in food prices and a deceleration in other prices. After rising ½ percent over the 12 months of 2008, overall prices for personal consumption expenditures rose about 2 percent in 2009. In contrast, the core PCE price index—which excludes the prices of energy items as well as those of food and beverages—increased a little less than 1½ percent in 2009, compared with a rise of roughly 1¾ percent in 2008 (figure 32). Data for PCE prices in January 2010 are not yet available, but information from the consumer price index and other sources suggests that inflation remained subdued.

32. Change in the chain-type price index for personal consumption expenditures, 2003–09



NOTE: Change is from December to December.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Consumer energy prices rose sharply in 2009, reversing much of the steep decline recorded in 2008. The retail price of gasoline was up more than 60 percent for the year as a whole, driven higher by a resurgence in the cost of crude oil. Reflecting the burgeoning supplies from new domestic wells, consumer natural gas prices fell sharply over the first half of 2009, before increasing again in the last few months of the year as the economic outlook improved. Electricity prices also fell during the early part of 2009 before retracing part of that decline later in the year. Overall, natural gas prices were down almost 20 percent in 2009, while electricity prices were about unchanged.

After posting sizable declines throughout much of 2009, food prices turned up modestly in the fourth quarter of last year. For the year as a whole, consumer food prices fell 1½ percent after rising 6¾ percent in 2008; these changes largely reflected the pass-through to retail of huge swings in spot prices of crops and livestock over the past two years.

Excluding food and energy, PCE price inflation slowed last year. Core PCE prices rose at an annual rate of 1¾ percent in the first half of 2009, similar to the pace in 2008, and then increased at an annual rate of only a little above 1 percent over the final six months of the year. This slowdown in core inflation was centered in a noticeable deceleration in the prices of nonenergy services. For those prices, firms' widespread cost-cutting efforts over the past year and the continued weakness in the housing market that has put downward pressure on housing costs have likely been important factors. The prices of many core consumer goods continued to rise only moderately in 2009; a notable exception was tobacco, for which tax-induced price hikes were substantial.

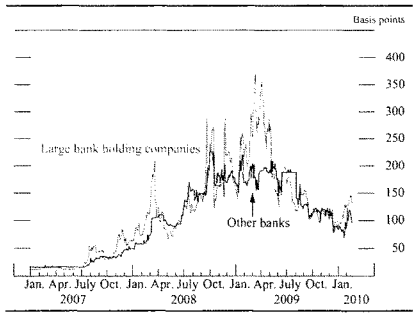
Survey-based measures of near-term inflation expectations, which were unusually low in the beginning of 2009, moved up, on average, over the remainder of the year. According to the Thomson Reuters/University of Michigan Surveys of Consumers, median expectations for year-ahead inflation stood at 2.8 percent in January, up from about 2 percent at the beginning of 2009. Historically, this short-term measure has been influenced fairly heavily by contemporaneous movements in energy prices. Longer-term inflation expectations, by contrast, have been relatively stable over the past year. For example, the Thomson Reuters/University of Michigan survey measure of median 5- to 10-year inflation expectations was 2.9 percent in January of this year, similar to the readings during most of 2009, and near the lower end of the narrow range that has prevailed over the past few years.

Financial Stability Developments

Evolution of the Financial Sector, Policy Actions, and Market Developments

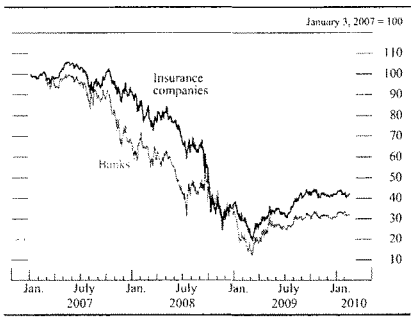
The recovery in the financial sector that began in the first half of 2009 continued through the second half of the year and into 2010, as investor concerns about the health of large financial institutions subsided further. Credit default swap (CDS) spreads for banking institutions—which primarily reflect investors' assessments of and willingness to bear the risk that those institutions will default on their debt obligations—fell considerably from their peaks early in 2009, although they remain above pre-crisis levels (figure 33). Bank equity prices have increased significantly since spring 2009 (figure 34). Many of the largest bank holding companies were able to issue equity and repurchase preferred shares that had been issued to the Treasury under the TARP. Nonetheless, conditions in many banking markets remain very challenging, with delinquency and charge-off rates still elevated, especially on commercial and residential real estate loans. Investor concerns about insurance companies—which had come under pressure in early 2009 and a few of which had received capital injections from the Treasury—also diminished, as indicated by narrowing CDS spreads for those firms and increases in their equity prices. In December, the Treasury announced that it was amending the cap on its Preferred Stock Purchase Agreements with Fannie Mae and Freddie Mac to ensure that each firm would maintain positive net worth for the next three years, and it

33. Spreads on credit default swaps for selected U.S. banks, 2007–10



NOTE: The data are daily and extend through February 18, 2010. Median spreads for six bank holding companies and nine other banks.
SOURCE: Markit.

34. Equity price indexes for banks and insurance companies, 2007–10



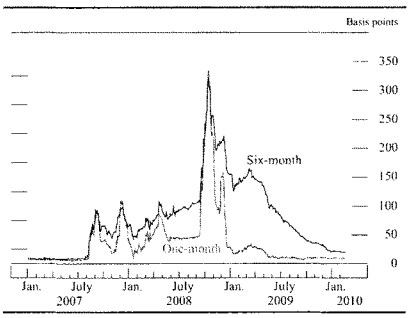
NOTE: The data are daily and extend through February 18, 2010.
SOURCE: Standard & Poor's.

also announced that it was providing additional capital to GMAC under the TARP.

Consistent with diminishing concerns about the conditions of banking institutions, functioning in bank funding markets has improved steadily since the spring of last year. A measure of stress in these markets—the spread between the London interbank offered rate (Libor) and the rate on comparable-maturity overnight index swaps (OIS)—narrowed at all maturities; spreads at shorter maturities reached pre-crisis levels, while those at longer maturities remained somewhat elevated by historical standards (figure 35). Liquidity in term bank funding markets also improved at terms up to six months. Conditions improved in other money markets as well. Bid-asked spreads and haircuts applied to collateral in repurchase agreement (repo) markets retraced some of the run-ups that had occurred during the financial market turmoil, though haircuts on most types of collateral continued to be sizable relative to pre-crisis levels. In the commercial paper market, spreads between rates on lower-quality A2/P2 paper and on asset-backed commercial paper over higher-quality AA nonfinancial paper fell to the low end of the range observed since the fall of 2007 (figure 36).

With improved conditions in financial markets, the Federal Reserve and other agencies removed some of the extraordinary support that had been provided during the crisis. Starting in the second half of 2009, the Federal Reserve began to normalize its lending to commercial banks. The amounts and maturity of credit auctioned through the Term Auction Facility (TAF) were reduced over time, and early in 2010 the Federal Reserve announced that the final TAF auction would be conducted in March 2010. Later, the Federal Reserve

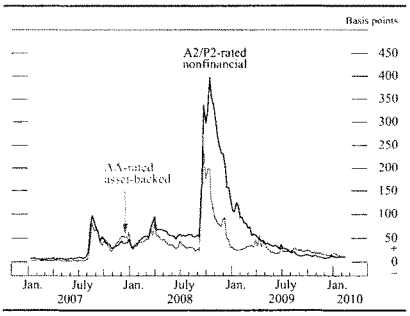
35. Libor minus overnight index swap rate, 2007–10



NOTE: The data are daily and extend through February 19, 2010. An overnight index swap (OIS) is an interest rate swap with the floating rate tied to an index of daily overnight rates, such as the effective federal funds rate. At maturity, two parties exchange, on the basis of the agreed notional amount, the difference between interest accrued at the fixed rate and interest accrued by averaging the floating, or index, rate. Libor is the London interbank offered rate.
SOURCE: For Libor, British Bankers' Association; for the OIS rate, Prebon.

noted that the minimum bid rate for the final auction would be 50 basis points, ¼ percentage point higher than in recent auctions. The Federal Reserve also shortened the maximum maturity of loans provided under the primary credit program from 90 days to 28 days, effective on January 14, and announced a further reduction of the maximum maturity of those loans to overnight effective March 18. In addition, the rate charged on primary credit loans was increased from ½ percent to ¾ percent effective February 19. Amounts outstanding under many of the Federal Reserve's special

36. Commercial paper spreads, 2007–10

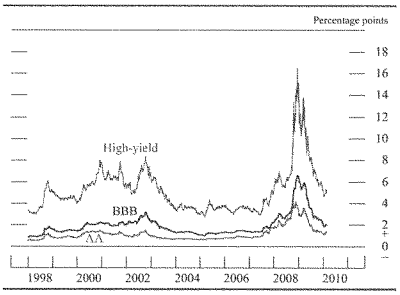


NOTE: The data are weekly and extend through February 17, 2010. Commercial paper yield spreads are for an overnight maturity and are expressed relative to the AA nonfinancial rate.
SOURCE: Depository Trust and Clearing Corporation.

liquidity facilities had dwindled to zero (or near zero) over the second half of 2009 as functioning of funding markets, both in the United States and abroad, continued to normalize. The Primary Dealer Credit Facility, the Term Securities Lending Facility, the Commercial Paper Funding Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and the temporary liquidity swap lines with foreign central banks were all allowed to expire on February 1, 2010. Other government agencies also reduced their support to financial institutions. For instance, to buttress the liquidity of financial institutions, the FDIC had established in October 2008 a program to provide, in exchange for a fee, a guarantee on short- and medium-term debt issued by banking institutions. Financial institutions issued about $300 billion under this program, but use of the program declined after the summer of 2009 as financial institutions were able to successfully issue nonguaranteed debt. In light of these developments, the FDIC announced in late October 2009 that the guarantee program would be extended but with significant restrictions; no debt has been issued under the extended program.

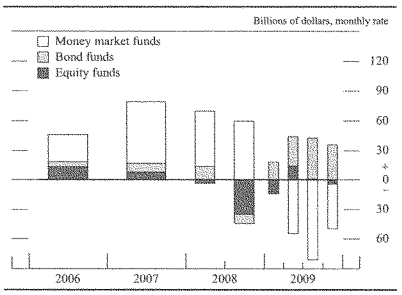
Asset prices in longer-term capital markets have also staged a noticeable recovery since the spring of 2009, and risk premiums have narrowed noticeably as investors' appetite for risk appears to be recovering. In the corporate bond market, risk spreads on both investment- and speculative-grade bonds—the difference between the yields on these securities and those on comparable-maturity Treasury securities—dropped, and by the end of last year those spreads were within ranges observed during the recoveries from previous recessions (figure 37). During the second half of 2009, the decline in risk spreads was accompanied by considerable inflows into mutual funds that invest in corporate bonds (figure 38). In the leveraged loan market, the average bid price climbed back toward par, and bid-asked spreads narrowed noticeably as trading conditions reportedly improved (figure 39). Equity markets rebounded significantly over the past few quarters, leaving broad equity market indexes about 65 percent above the low point reached in March 2009 (figure 40).

37. Spreads of corporate bond yields over comparable off-the-run Treasury yields, by securities rating, 1998–2010



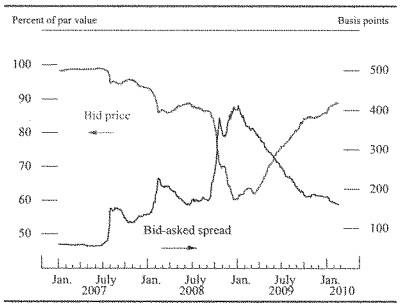
NOTE: The data are daily and extend through February 18, 2010. The spreads shown are the yields on 10-year bonds less the 10-year Treasury yield.
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

38. Net flows into mutual funds, 2006–09



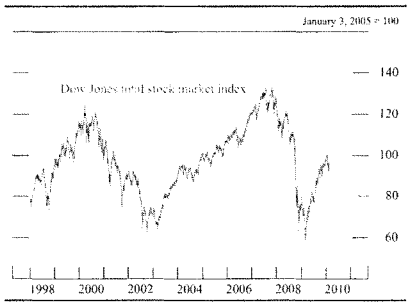
NOTE: The data exclude reinvested dividends and are not seasonally adjusted.
SOURCE: Federal Reserve Board, flow of funds data.

39. Secondary-market pricing for syndicated loans, 2007–10



NOTE: The data are daily and extend through February 18, 2010.
SOURCE: LSTA/Thomson Reuters Mark-to-Market Pricing.

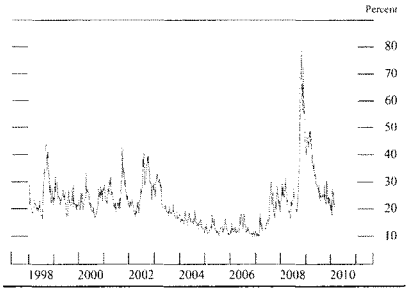
40. Stock price index, 1998–2010



NOTE: The data are daily and extend through February 18, 2010.
SOURCE: Dow Jones Indexes.

Overall, the rebound in asset prices likely reflected corporate earnings that were generally above market expectations, improved measures of corporate credit quality, and brighter economic prospects. Apparently, investors also became somewhat less concerned about the downside risks to the economic outlook, as suggested by declines in measures of uncertainty and risk premiums. Implied volatility on the S&P 500, as calculated from option prices, held at moderate levels during the second half of 2009 and was well off the peak reached in November 2008 (figure 41). Moreover, a measure of the premium that investors require for holding equity shares—the difference between the ratio of 12-month forward expected earnings to equity prices for S&P 500 firms and the long-term real Treasury yield—narrowed in 2009, though it remains elevated by historical standards.

41. Implied S&P 500 volatility, 1998–2010



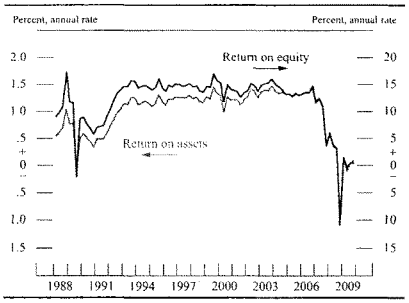
NOTE: The data are weekly and extend through the week ending February 19, 2010. The final observation is an estimate based on data through February 18, 2010. The series shown—the VIX—is the implied 30-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

Banking Institutions

The profitability of the commercial banking sector, as measured by the return on equity, continued to be quite low during the second half of 2009 (figure 42). Elevated loan loss provisioning continued to be the largest factor restraining earnings; however, provisioning decreased significantly in the second half of the year, suggesting that banks believe that credit losses may be stabilizing. While some banks saw earnings boosted earlier last year by gains in trading and investment banking activities, revenue from these sources is reported to have dropped back in the fourth quarter. Although delinquency and charge-off rates for residential mortgages and commercial real estate loans continued to climb in the second half of 2009, for most other types of loans these metrics declined or showed signs of leveling out.

During the year, bank holding companies issued substantial amounts of common equity. Significant issuance occurred in the wake of the release of the Supervisory Capital Assessment Program (SCAP) results, which indicated that some firms needed to augment or improve the quality of their capital in order to assure that, even under a macroeconomic scenario that was more adverse than expected, they would emerge from the subsequent two-year period still capable of meeting the needs of creditworthy borrowers. The 19 SCAP firms issued about $110 billion in new common equity; combined with conversions of preferred stock, asset

42. Commercial bank profitability, 1988–2009



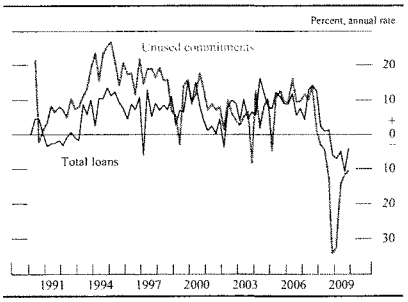
NOTE: The data are quarterly and extend through 2009:Q4.
SOURCE: Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

sales, and other capital actions, these steps have added more than $200 billion to common equity since the beginning of 2009. Equity offerings were also undertaken by other financial firms, and some used the proceeds to repay funds received as part of the Capital Purchase Program.

Against a backdrop of weak loan demand and tight credit policies throughout 2009, total loans on banks' books contracted even more sharply in the last two quarters taken together than in the first half of the year (figure 43). Outstanding unused loan commitments to both businesses and households also declined, albeit at a slower pace than in early 2009. The decline in loans was partially offset by an increase in holdings of securities, particularly Treasury securities and agency MBS, and a further rise in balances at the Federal Reserve. On balance, total industry assets declined. The decline in assets combined with an increase in capital to push regulatory capital ratios considerably higher.

The Financial Accounting Standards Board published Statements of Financial Accounting Standards Nos. 166 and 167 (FAS 166 and 167) in June 2009. The new standards modified the basis for determining whether a firm must consolidate securitized assets (as well as the associated liabilities and equity) onto its balance sheet; most banking organizations must implement the standards in the first quarter of 2010. Industry analysts estimate that banking organizations will consolidate approximately $600 billion of additional assets as a result of implementing FAS 166 and 167. A small number of institutions with large securitization programs will be most affected. While the regulatory capital ratios of the affected banking organizations may decrease after implementation of FAS 166 and 167, the ratios of organizations most affected by the accounting change are expected to remain substantially in excess of regulatory minimums. The federal banking agencies recently published a related risk-based capital rule that includes an optional one-year phase-in of certain risk-based capital impacts resulting from implementation of FAS 166 and 167.[16]

43. Change in total bank loans and unused bank loan commitments to businesses and households, 1990–2009



NOTE: The data, which are not seasonally adjusted, are quarterly and extend through 2009:Q4. Total loans are adjusted to remove the effects of large thrifts converting to commercial banks or merging with a commercial bank.

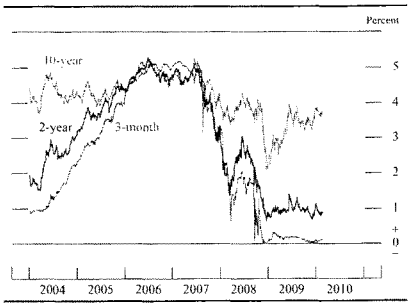
SOURCE: Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Monetary Policy Expectations and Treasury Rates

In July 2009, market participants had expected the target federal funds rate to be close to the current target range of 0 to ¼ percent in early 2010, but they had also anticipated that the removal of policy accommodation would be imminent. Over the second half of 2009, however, investors marked down their expectations for the path of the federal funds rate. Quotes on futures contracts imply that, as of mid-February 2010, market participants anticipate that policy will be tightened beginning in the third quarter of 2010, and that the tightening will proceed at a pace slower than was expected last summer. However, uncertainty about the size of term premiums and potential distortions created by the zero lower bound for the federal funds rate continue to make it difficult to obtain a definitive reading on the policy expectations of market participants from futures prices. The downward revision in policy expectations since July likely has reflected incoming economic data pointing to a somewhat weaker trajectory for employment and a lower path for inflation than had been anticipated. Another contributing factor likely was Federal Reserve communications, including the reiteration in the statement released after each meeting of the Federal Open Market Committee that economic conditions are likely

16. For more information and the text of the final rule, see Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (2010), "Agencies Issue Final Rule for Regulatory Capital Standards Related to Statements of Financial Accounting Standards Nos. 166 and 167," press release, January 21, www.federalreserve.gov/newsevents/press/bcreg/20100121a.htm. The final rule was also published in the *Federal Register*; see Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (2010), "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues," final rule, *Federal Register*, vol. 75 (January 28), pp. 4636–54.

44. Interest rates on selected Treasury securities, 2004–10



NOTE: The data are daily and extend through February 18, 2010.
SOURCE: Department of the Treasury.

to warrant exceptionally low levels of the federal funds rate for an extended period.

Yields on shorter-maturity Treasury securities have edged lower since last summer, consistent with the downward shift in the expected policy path (figure 44). However, yields on longer-maturity nominal Treasury securities have increased slightly, on net, likely in response to generally positive news about the economy and declines in the weight investors had placed on extremely adverse economic outcomes. The gradual tapering and the completion of the Federal Reserve's large-scale asset purchases of Treasury securities in October 2009 appeared to put little upward pressure on Treasury yields.

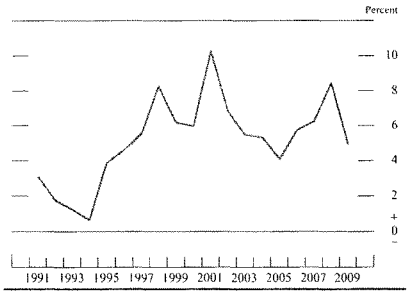
Yields on Treasury inflation-protected securities (TIPS) declined somewhat in the second half of 2009 and into 2010. The result was an increase in inflation compensation—the difference between comparable-maturity nominal yields and TIPS yields. The increase was concentrated at shorter-maturities and was partly a response to rising prices of oil and other commodities. Inflation compensation at more distant horizons was somewhat volatile and was little changed on net. Inferences about investors' inflation expectations have been more difficult to make since the second half of 2008 because special factors, such as safe-haven demands and an increased preference of investors for liquid assets, appear to have significantly affected the relative demand for nominal and inflation-indexed securities. These special factors began to abate in the first half of 2009 and receded further in the second half of the year, and the resulting changes in nominal and inflation-adjusted yields may have accounted for part of the recent increase in inflation compensation. On net, survey measures of longer-run inflation expectations have remained stable.

Monetary Aggregates and the Federal Reserve's Balance Sheet

After a brisk increase in the first half of the year, the M2 monetary aggregate expanded slowly in the second half of 2009 and in early 2010 (annual growth rate shown in figure 45).[17] The rise in the latter part of the year was driven largely by increases in liquid deposits, as interest rates on savings deposits were reduced more slowly than rates on other types of deposits, and households and firms maintained some preference for safe and liquid assets. Outflows from small time deposits and retail money market mutual funds intensified during the second half of 2009, likely because of ongoing declines in the interest rates offered on these products. The currency component of the money stock expanded

17. M2 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; (4) other checkable deposits (negotiable order of withdrawal, or NOW, accounts and automatic transfer service accounts at depository institutions; credit union share draft accounts; and demand deposits at thrift institutions); (5) savings deposits (including money market deposit accounts); (6) small-denomination time deposits (time deposits issued in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (7) balances in retail money market mutual funds less IRA and Keogh balances at money market mutual funds.

45. M2 growth rate, 1991–2009



NOTE: The data extend through 2009 and are annual on a fourth-quarter over fourth-quarter basis. For definition of M2, see text note 17.
SOURCE: Federal Reserve Board, Statistical Release H.6, "Money Stock Measures."

modestly in the second half of the year. The monetary base—essentially the sum of currency in circulation and the reserve balances of depository institutions held at the Federal Reserve—expanded rapidly for much of the second half of 2009, as the increase in reserve balances resulting from the large-scale asset purchases more than offset the decline caused by reduced usage of the Federal Reserve's credit programs. However, the monetary base increased more slowly toward the end of 2009 and early 2010 as these purchases were tapered and as use of Federal Reserve liquidity facilities declined.

1. Selected components of the Federal Reserve balance sheet, 2008–10

Millions of dollars

Balance sheet item	Dec. 31, 2008	July 15, 2009	Feb. 17, 2010
Total assets	**2,240,946**	**2,074,822**	**2,280,952**
Selected assets			
Credit extended to depository institutions and dealers			
Primary credit	93,769	34,743	14,156
Term auction credit	450,219	273,691	15,426
Central bank liquidity swaps	553,728	111,641	0
Primary Dealer Credit Facility and other broker-dealer credit	37,404	0	0
Credit extended to other market participants			
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility	23,765	5,469	0
Net portfolio holdings of Commercial Paper Funding Facility LLC	334,102	111,053	7,721
Net portfolio holdings of LLCs funded through the Money Market Investor Funding Facility	0	0	0
Term Asset-Backed Securities Loan Facility	...	30,124	47,182
Support of critical institutions			
Net portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC[1]	73,925	60,546	65,089
Credit extended to American International Group, Inc.	38,914	42,871	25,535
Preferred interests in AIA Aurora LLC, and ALICO Holdings LLC	...	...	25,106
Securities held outright			
U.S. Treasury securities	475,921	684,030	776,571
Agency debt securities	19,708	101,701	165,587
Agency mortgage-backed securities (MBS)[2]	...	526,418	1,025,541
MEMO			
Term Securities Lending Facility[3]	171,600	4,250	0
Total liabilities	**2,198,794**	**2,025,348**	**2,228,425**
Selected liabilities			
Federal Reserve notes in circulation	853,168	870,327	892,985
Reserve balances of depository institutions	860,000	808,824	1,205,165
U.S. Treasury, general account	106,123	65,234	49,702
U.S. Treasury, supplemental financing account	259,325	199,939	5,000
Total capital	**42,152**	**49,474**	**52,527**

NOTE: LLC is a limited liability company.

1. The Federal Reserve has extended credit to several LLCs in conjunction with efforts to support critical institutions. Maiden Lane LLC was formed to acquire certain assets of The Bear Stearns Companies, Inc. Maiden Lane II LLC was formed to purchase residential mortgage-backed securities from the U.S. securities lending reinvestment portfolio of subsidiaries of American International Group, Inc. (AIG). Maiden Lane III LLC was formed to purchase multisector collateralized debt obligations on which the Financial Products group of AIG had written credit default swap contracts.

2. Includes only MBS purchases that have already settled.

3. The Federal Reserve retained ownership of securities lent through the Term Securities Lending Facility.

... Not applicable.

SOURCE: Federal Reserve Board.

The nontraditional monetary policy actions taken by the Federal Reserve since the onset of the financial crisis expanded the size of the Federal Reserve's balance sheet considerably during 2008, and it remained very large throughout 2009 and into 2010 (table 1). Total Federal Reserve assets on February 17, 2010, stood at about $2.3 trillion. The compositional shifts that had been under way in the first half of 2009 continued during the remainder of the year. Lending to depository institutions as well as credit extended under special liquidity facilities and the temporary liquidity swaps with foreign central banks contracted sharply. By contrast, the large-scale asset purchases conducted by the Federal Reserve boosted securities held outright. Holdings of agency MBS surpassed $1 trillion early this year, up from about $525 billion in mid-July 2009. For other types of securities, the increases were more modest, with holdings of agency debt expanding from about $100 billion in July 2009 to $165 billion in February and holdings of Treasury securities rising from nearly $700 billion to approximately $775 billion over the same period. The revolving credit provided to American International Group, Inc. (AIG), declined near year-end, as the outstanding balance was reduced in exchange for preferred interests in AIA Aurora LLC and ALICO Holdings LLC, which are life insurance holding company subsidiaries of AIG. Loans related to the Maiden Lane facilities—which represent credit extended in conjunction with efforts to avoid disorderly failures of The Bear Stearns Companies, Inc., and AIG—stayed roughly steady. On the liability side of the Federal Reserve's balance sheet, reserve balances increased from slightly more than $800 billion in July to about $1.2 trillion as of February 17, 2010, while the Treasury's supplementary financing account fell to $5 billion; the decline in the supplementary financing account occurred late in 2009 as part of the Treasury's efforts to retain flexibility in debt management as federal debt approached the debt ceiling.

INTERNATIONAL DEVELOPMENTS

International Financial Markets

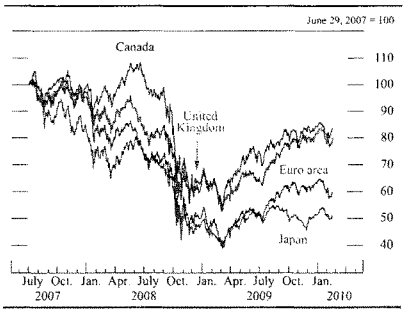
Global financial markets recovered considerably in 2009 as the effectiveness of central bank and govern-

ment actions in stabilizing the financial system became more apparent and as signs of economic recovery began to take hold. Stock markets in the advanced foreign economies registered gains of about 50 percent from their troughs in early March, although they remain below their levels at the start of the financial crisis in August 2007 (figure 46). Stock markets in the emerging market economies rebounded even more impressively over the year. Most Latin American and many emerging Asian stock markets are now close to their levels at the start of the crisis (figure 47).

As global prospects improved, investors shifted away from the safe-haven investments in U.S. securities they had made at the height of the crisis. As a result, the dollar, which had appreciated sharply in late 2008, depreciated against most other currencies in the second and third quarters of 2009. The dollar depreciated particularly sharply against the currencies of major commodity-producing nations, such as Australia and Brazil, as rising commodity prices supported economic recovery in those countries. In the fourth quarter, the dollar stabilized and has since appreciated somewhat, on net, as investors began to focus more on economic news and prospects for the relative strength of the economic recoveries in the United States and elsewhere (figure 48). Chinese authorities held the renminbi steady against the dollar throughout the year. For 2009 as a whole, the dollar depreciated roughly 4½ percent on a trade-weighted basis against the major foreign currencies (figure 49) and 3½ percent against the currencies of the other important trading partners of the United States.

Sovereign bond yields in the advanced economies rose over most of 2009 as investors moved out of safe investments in government securities and became more willing to purchase riskier securities. Concerns about rising budget deficits in many countries and the asso-

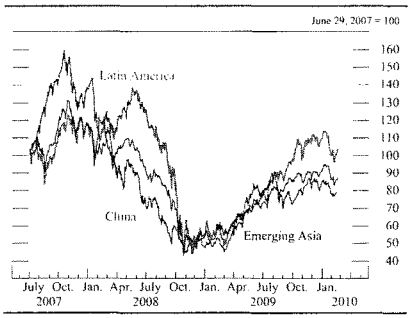
46. Equity indexes in selected advanced foreign economies, 2007–10



NOTE: The data are daily. The last observation is February 18, 2010, for the euro area, Japan, and the United Kingdom and February 17, 2010, for Canada.

SOURCE: For euro area, Dow Jones Euro STOXX Index; for Canada, Toronto Stock Exchange 300 Composite Index; for Japan, Tokyo Stock Exchange (TOPIX); and for the United Kingdom, London Stock Exchange (FTSE 350), as reported by Bloomberg.

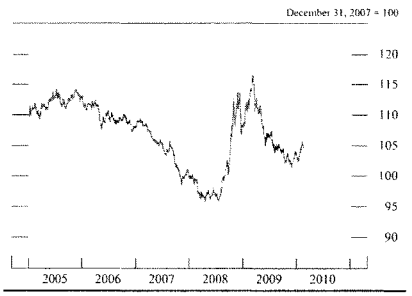
47. Equity indexes in selected emerging market economies, 2007–10



NOTE: The data are daily. The last observation is February 17, 2010, for Latin America and emerging Asia and February 12, 2010, for China. In this figure, the Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, and Peru; the emerging Asian economies are China, India, Indonesia, Malaysia, Pakistan, the Philippines, South Korea, Taiwan, and Thailand.

SOURCE: For Latin America and emerging Asia, Morgan Stanley Capital International (MSCI) index; for China, Shanghai Composite Index, as reported by Bloomberg.

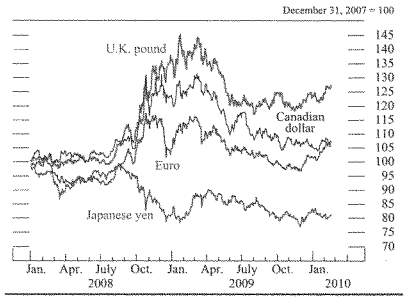
48. U.S. dollar nominal exchange rate, broad index, 2005–10



NOTE: The data, which are in foreign currency units per dollar, are daily. The last observation for the series is February 18, 2010. 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.

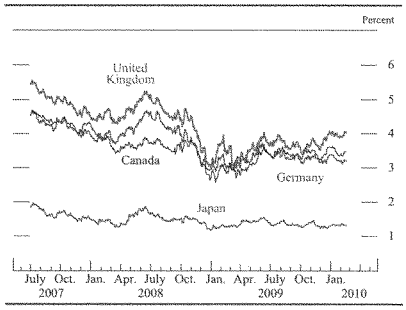
SOURCE: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

49. U.S. dollar exchange rate against selected major currencies, 2008–10



NOTE: The data, which are in foreign currency units per dollar, are daily. The last observation for each series is February 18, 2010.
SOURCE: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

50. Yields on benchmark government bonds in selected advanced foreign economies, 2007–10



NOTE: The data, which are for 10-year bonds, are daily. The last observation for each series is February 18, 2010.
SOURCE: Bloomberg.

ciated borrowing needs also likely contributed to the increase in yields. Late in the year, the announcement of a substantial upward revision to the budget deficit in Greece led to a sharp rise in spreads of Greece's sovereign debt over comparable yields on Germany's sovereign debt. These spreads remained elevated in early 2010 and also increased in other euro-area countries with sizable budget deficits, especially Portugal and Spain. Sovereign yields in most of the advanced economies, however, remained significantly lower than prior to the financial crisis, as contained inflation, expectations of only slow economic recovery, and easing of monetary policy by central banks have all worked to keep long-term nominal interest rates low (figure 50).

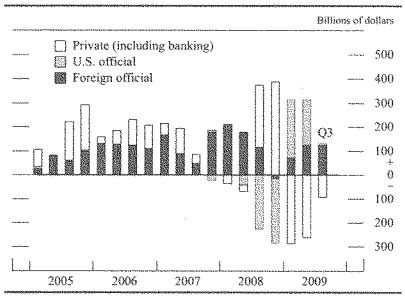
Conditions in global money markets have continued to improve. One-month Libor-OIS spreads in euros and sterling are now less than 10 basis points, near their levels before the crisis. Dollar funding pressures abroad have also substantially abated, and foreign firms are more easily able to obtain dollar funding through private markets such as those for foreign exchange swaps. As a result, drawings on the Federal Reserve's temporary liquidity swap lines by foreign central banks declined in the second half of 2009 to only about $10 billion by the end of the year, and funding markets continued to function without disruption as these swap lines expired on February 1, 2010.

The Financial Account

The pattern of financial flows between the United States and the rest of the world in 2009 reflected the recovery under way in global markets. As the financial crisis eased, net bank lending abroad resumed, but the recovery in portfolio flows was mixed.

Total private financial flows reversed from the large net inflows that had characterized the second half of 2008 to large net outflows in the first half of 2009 (figure 51). This reversal primarily reflected changes in net bank lending. Banks located in the United States had sharply curtailed their lending abroad as the financial crisis intensified in the third and fourth quarters of 2008, and they renewed their net lending as functioning of interbank markets improved in the first half of 2009. During the second half of 2009, interbank market

51. U.S. net financial inflows, 2005–09



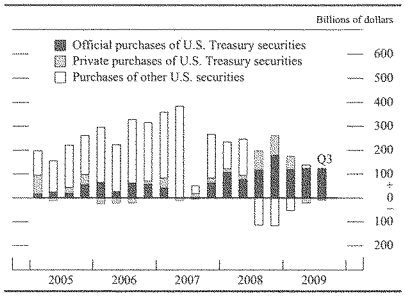
NOTE: U.S. official flows include foreign central banks' drawings on their swap lines with the Federal Reserve.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

conditions continued to normalize, and net bank lending proceeded at a moderate pace. The increased availability of funding in private markets also led to reduced demand from foreign central banks for drawings on the liquidity swap lines with the Federal Reserve. Repayment of the drawings in the first half of 2009 generated sizable U.S. official inflows that offset the large private banking outflows.

Foreign official institutions continued purchasing U.S. Treasury securities at a strong pace throughout 2009, as they had during most of the crisis (figure 52). Foreign exchange intervention by several countries to counteract upward pressure on their currencies gave a boost to these purchases. Countries conducting such intervention bought U.S. dollars in foreign currency markets and acquired U.S. assets, primarily Treasury securities, with the proceeds.

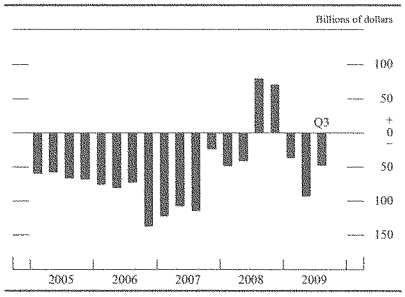
During the height of the crisis, private foreign investors had also purchased record amounts of U.S. Treasury securities, likely reflecting safe-haven demands. Starting in April 2009, as improvement in financial conditions became more apparent, private foreigners began to sell U.S. Treasury securities, but net sales in the second and third quarters were modest compared with the amounts acquired in previous quarters. The recovery in foreign demand for riskier U.S. securities was mixed. Foreign investment in U.S. equities picked up briskly after the first quarter of 2009, nearly reaching a pre-crisis pace. However, foreign investors continued small net sales of U.S. corporate and agency debt. Meanwhile, U.S. investment in foreign securities bounced back quickly and remained strong throughout 2009 (figure 53).

52. Net foreign purchases of U.S. securities, 2005–09



NOTE: Other U.S. securities include corporate equities and bonds, agency bonds, and municipal bonds.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

53. Net U.S. purchases of foreign securities, 2005–09



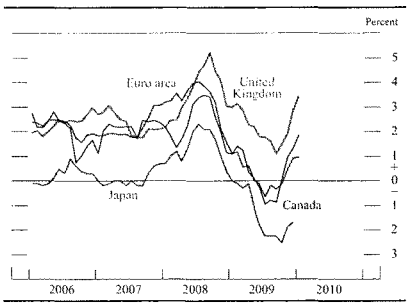
NOTE: Negative numbers indicate a balance of payments outflow associated with positive U.S. purchases of foreign securities.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Advanced Foreign Economies

Economic activity in the advanced foreign economies continued to fall sharply in early 2009 but began to recover later in the year as financial conditions improved and world trade rebounded. The robust recovery in emerging Asia helped the Japanese economy to turn up in the second quarter, and other major foreign economies returned to positive economic growth in the second half. Nevertheless, performance has been mixed. Spurred by external demand and a reduction in the pace of inventory destocking, industrial production has risen in most countries but remains well below pre-crisis levels. Business confidence has shown considerable improvement, and survey measures of manufacturing activity have risen as well. Consumer confidence also has improved as financial markets have stabilized, but household finances remain stressed, with unemployment at high levels and wage gains subdued. Although government incentives helped motor vehicle purchases to bounce back from the slump in early 2009, other household spending has remained sluggish in most countries. Housing prices have recovered somewhat in the United Kingdom and more in Canada but have continued to decline in Japan and in some euro-area countries.

Twelve-month consumer price inflation moved lower through the summer, with headline inflation turning negative in all the major advanced foreign countries except the United Kingdom. However, higher energy prices in the second half of 2009 pushed inflation back into positive territory except in Japan (figure 54). Core consumer price inflation, which excludes food and energy, has fluctuated less.

54. Change in consumer prices for major foreign economies, 2006–10

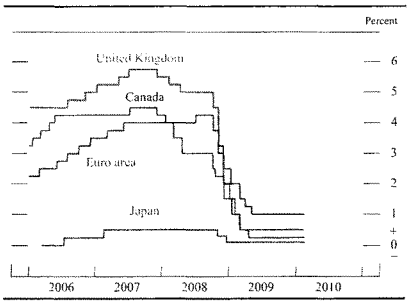


NOTE: The data are monthly, and the percent change is from one year earlier. The data extend through January 2010 for the euro area, Japan, and the United Kingdom and through December 2009 for Canada.

SOURCE: For the euro area, the European Central Bank; for the United Kingdom, the U.K. Office for National Statistics; for Japan, the Japan Statistics Bureau; and, for Canada, Statistics Canada; all via Haver Analytics.

Foreign central banks cut policy rates aggressively during the first half of 2009 and left those rates at historically low levels through year-end (figure 55). The European Central Bank (ECB) has held its main policy rate at 1 percent since May and has made significant amounts of long-term funding available at this rate, allowing overnight interest rates to fall to around 0.35 percent. The Bank of Canada has indicated that it expects to keep its target for the overnight rate at a record low 0.25 percent until at least mid-2010. In addition to their interest rate moves, foreign central banks pursued unconventional monetary easing. The Bank of England continued its purchases of British treasury securities, increasing its Asset Purchase Facility from £50 billion to £200 billion over the course of the year. Amid concerns about persistent deflation, the Bank of Japan announced a new ¥10 trillion three-month secured lending facility at an unscheduled meeting on December 1. The ECB has continued its planned purchases of up to €60 billion in covered bonds, but it has also taken some initial steps toward scaling back its enhanced credit support measures, as it sees reduced need for special programs to provide liquidity.

55. Official or targeted interest rates in selected advanced foreign economies, 2006–10



NOTE: The data are daily and extend through February 18, 2010. The data shown are, for Canada, the overnight rate; for the euro area, the minimum bid rate on main refinancing operations; for Japan, the uncollateralized overnight call rate; and, for the United Kingdom, the official bank rate paid on commercial reserves.

SOURCE: The central bank of each area or country shown.

Emerging Market Economies

Recovery from the global financial crisis has been more pronounced in the emerging market economies than in the advanced foreign economies. In aggregate, emerging market economies continued to contract in the first quarter of 2009, but economic activity in many countries, particularly in emerging Asia, rebounded sharply in the second quarter and remained robust in the second half of the year. The upturn in economic activity was driven largely by domestic demand, which received strong boosts from monetary and fiscal stimulus. By the end of 2009, the level of real GDP in several emerging market economies had recovered to or was approaching pre-crisis peaks. With significant spare capacity as a result of the earlier steep contraction in activity in these economies, inflation remained generally subdued through the first half of last year but moved up in the fourth quarter as adverse weather conditions led to a sharp rise in food prices.

In China, the fiscal stimulus package enacted in November 2008, combined with a surge in bank lending, led to a sharp rise in investment and consumption. Strong domestic demand contributed to a rebound in imports, which helped support economic activity in the rest of Asia and in commodity-exporting countries. Chinese authorities halted the modest appreciation of their currency against the dollar in the middle of 2008, and the exchange rate between the renminbi and the dollar has been unchanged since then. In the second half of 2009, authorities acted to slow the increase in bank lending to a more sustainable pace after the level of outstanding loans rose in the first half of the year by nearly one-fourth of nominal GDP. With the economy booming and inflation picking up, the People's Bank of China (the central bank) increased the required reserve ratio for banks ½ percentage point in January 2010 and again

in February, the country's first significant monetary policy tightening moves since the financial crisis. In China and elsewhere in Asia, asset prices have rebounded sharply after falling steeply in the second half of 2008.

In Latin America, the rebound in activity has lagged that in Asia. Economic activity in Mexico, which is more closely tied to U.S. production and was adversely affected by the outbreak of the H1N1 virus last spring, did not turn up until the third quarter of 2009, but it then grew rapidly. In Brazil, the recession was less severe than in Mexico, and economic growth has been fairly strong since the second quarter of last year, supported in part by government stimulus and rising commodity prices.

Russia and many countries in emerging Europe suffered severe output contractions in the first half of 2009 and, in some cases, further financial stresses. In particular, Latvia faced difficulties meeting the fiscal conditions of its international assistance package, which heightened concerns about the survival of the Latvian currency regime. However, economic and financial conditions in emerging Europe began to recover in the second half of the year.

Part 3
Monetary Policy: Recent Developments and Outlook

Monetary Policy over the Second Half of 2009 and Early 2010

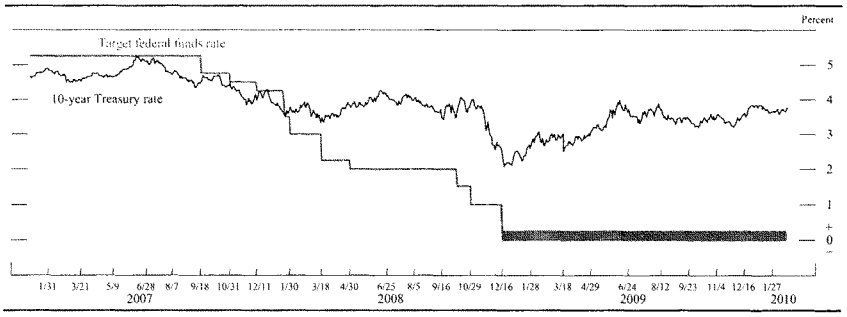
In order to provide monetary stimulus to support a sustainable economic expansion, the Federal Open Market Committee (FOMC) maintained a target range for the federal funds rate of 0 to ¼ percent throughout 2009 and into early 2010 (figure 56). The Federal Reserve also continued its program of large-scale asset purchases, completing purchases of $300 billion in Treasury securities and making considerable progress toward completing its announced purchases of $1.25 trillion of agency mortgage-backed securities (MBS) and about $175 billion of agency debt.

However, with financial market conditions improving, the Federal Reserve took steps to begin winding down many of its special credit and liquidity programs in 2009. On June 25, the Federal Reserve announced that it was extending the authorizations of several of these programs from October 30, 2009, to February 1, 2010. However, the terms of some of these facilities were tightened somewhat, the amounts to be offered under the Term Auction Facility (TAF) were reduced, and the authorization for the Money Market Investor Funding Facility was not extended.[18] Over the summer, the Federal Reserve continued to trim the amounts offered through the TAF.

The information reviewed at the August 11–12 FOMC meeting suggested that overall economic activity was stabilizing after having contracted during 2008 and early 2009. Nonetheless, meeting participants generally saw the economy as likely to recover only slowly during the second half of 2009 and as still vulnerable to adverse shocks. Although housing activity apparently was beginning to turn up, the weak labor market continued to restrain household income, and earlier declines in net worth were still holding back spending. Develop-

18. In particular, the Federal Reserve began requiring money market mutual funds to have experienced redemptions exceeding a certain threshold before becoming eligible to borrow from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The Federal Reserve also suspended auctions conducted under the Term Securities Lending Facility (TSLF) involving only Schedule 1 collateral and reduced the frequency of TSLF auctions involving Schedule 2 collateral. Schedule 1 collateral refers to securities eligible for the open market operations arranged by the Federal Reserve's Open Market Trading Desk—generally Treasury securities, agency debt, or agency MBS. Schedule 2 collateral includes all Schedule 1 collateral as well as investment-grade corporate, municipal, mortgage-backed, and asset-backed securities.

56. Selected interest rates, 2007–10



NOTE: The data are daily and extend through February 18, 2010. The 10-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of regularly scheduled Federal Open Market Committee meetings.
SOURCE: Department of the Treasury and the Federal Reserve.

ments in financial markets leading up to the meeting were broadly positive, and the cumulative improvement in market functioning since the spring was significant. However, the pickup in financial markets was seen as due, in part, to support from various government programs. Moreover, credit remained tight, with many banks reporting that they continued to tighten loan standards and terms. Overall prices for personal consumption expenditures (PCE) rose in June after changing little in each of the previous three months. Excluding food and energy, PCE prices moved up moderately in June.

Given the prospects for an initially modest economic recovery, substantial resource slack, and subdued inflation, the Committee agreed at its August meeting that it should maintain its target range for the federal funds rate at 0 to ¼ percent. FOMC participants expected only a gradual upturn in economic activity and subdued inflation and thought it most likely that the federal funds rate would need to be maintained at an exceptionally low level for an extended period. With the downside risks to the economic outlook now considerably reduced but the economic recovery likely to be subdued, the Committee also agreed that neither expansion nor contraction of its program of asset purchases was warranted at the time. The Committee did, however, decide to gradually slow the pace of the remainder of its purchases of $300 billion of Treasury securities and extend their completion to the end of October to help promote a smooth transition in financial markets. Policymakers noted that, with the programs for purchases of agency debt and MBS not due to expire until the end of the year, they did not need to make decisions at the meeting about any potential modifications to those programs.

By the time of the September 22–23 FOMC meeting, incoming data suggested that overall economic activity was beginning to pick up. Factory output, particularly motor vehicle production, rose in July and August. Consumer spending on motor vehicles during that period was boosted by government rebates and greater dealer incentives. Household spending outside of motor vehicles appeared to rise in August after having been roughly flat from May through July. Sales data for July indicated further increases in the demand for both new and existing single-family homes. Although employment continued to contract in August, the pace of job losses had slowed noticeably from earlier in the year. Developments in financial markets were again regarded as broadly positive; meeting participants saw the cumulative improvement in market functioning and pricing since the spring as substantial. Despite these positive factors, participants still viewed the economic recovery as likely to be quite restrained. Credit from banks remained difficult to obtain and costly for many borrowers; these conditions were expected to improve only gradually. Many regional and small banks were vulnerable to the deteriorating performance of commercial real estate loans. In light of recent experience, consumers were likely to be cautious in spending, and business contacts indicated that their firms would also be cautious in hiring and investing even as demand for their products picked up. Some of the recent gains in economic activity probably reflected support from government policies, and participants expressed considerable uncertainty about the likely strength of the upturn once those supports were withdrawn or their effects waned. Core consumer price inflation remained subdued, while overall consumer price inflation increased in August, boosted by a sharp upturn in energy prices.

Although the economic outlook had improved further and the risks to the forecast had become more balanced, the recovery in economic activity was likely to be protracted. With substantial resource slack likely to persist and longer-term inflation expectations stable, the Committee anticipated that inflation would remain subdued for some time. Under these circumstances, the Committee judged that the costs of the economic recovery turning out to be weaker than anticipated could be relatively high. Accordingly, the Committee agreed to maintain its target range for the federal funds rate at 0 to ¼ percent and to reiterate its view that economic conditions were likely to warrant an exceptionally low level of the federal funds rate for an extended period. With respect to the large-scale asset purchase programs, the Committee indicated its intention to purchase the full $1.25 trillion of agency MBS that it had previously established as the maximum for this program. With respect to agency debt, the Committee agreed to reiterate its intention to purchase up to $200 billion of these securities. To promote a smooth transition in markets as these programs concluded, the Committee decided to gradually slow the pace of both its agency MBS and agency debt purchases and to extend their completion through the end of the first quarter of 2010. To keep inflation expectations well anchored, policymakers agreed on the importance of the Federal Reserve continuing to communicate that it has the tools and willingness to begin withdrawing monetary policy accommodation at the appropriate time and pace to prevent any persistent increase in inflation.

On September 24, the Board of Governors announced a gradual reduction in amounts to be auctioned under the TAF through January and indicated that auctions of credit with maturities longer than 28 days would be phased out by the end of 2009. Usage

of the TAF had been declining in recent months as financial market conditions had continued to improve. The Money Market Investor Funding Facility, which had been established in October 2008 to help arrest a run on money market mutual funds, expired as scheduled on October 30, 2009.

At the November 3–4 FOMC meeting, participants agreed that the incoming information suggested that economic activity was picking up as anticipated, with output continuing to expand in the fourth quarter. Business inventories were being brought into better alignment with sales, and the pace of inventory runoff was slowing. The gradual recovery in construction of single-family homes from its extremely low level earlier in the year appeared to be continuing. Consumer spending appeared to be rising even apart from the effects of fiscal incentives to purchase autos. Financial market developments over recent months were generally regarded as supportive of continued economic recovery. Further, the outlook for growth abroad had improved since earlier in the year, especially in Asia, auguring well for U.S. exports. Meanwhile, consumer price inflation remained subdued. In spite of these largely positive developments, participants at the November meeting noted that they were unsure how much of the recent firming in final demand reflected the effects of temporary fiscal programs. Downside risks to economic activity included continued weakness in the labor market and its implications for the growth of household income and consumer confidence. Bank credit remained tight. Nonetheless, policymakers expected the recovery to continue in subsequent quarters, although at a pace that would be rather slow relative to historical experience after severe downturns. FOMC participants noted the possibility that some negative side effects might result from the maintenance of very low short-term interest rates for an extended period, including the possibility that such a policy stance could lead to excessive risk-taking in financial markets or an unanchoring of inflation expectations. The Committee agreed that it was important to remain alert to these risks.

Based on this outlook, the Committee decided to maintain the target range for the federal funds rate at 0 to ¼ percent and noted that economic conditions, including low levels of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low rates for an extended period. With respect to the large-scale asset purchase programs, the Committee reiterated its intention to purchase $1.25 trillion of agency MBS by the end of the first quarter of 2010. Because of the limited availability of agency debt and concerns that larger purchases could impair market functioning, the Committee also agreed to specify that its agency debt purchases would cumulate to about $175 billion by the end of the first quarter, $25 billion less than the previously announced maximum for these purchases. The Committee also decided to reiterate its intention to gradually slow the pace of purchases of agency MBS and agency debt to promote a smooth transition in markets as the announced purchases are completed.

On November 17, the Board of Governors announced that, in light of continued improvement in financial market conditions, in January 2010 the maximum maturity of primary credit loans at the discount window for depository institutions would be reduced to 28 days from 90 days.

The information reviewed at the December 15–16 FOMC meeting suggested that the recovery in economic activity was gaining momentum. Although the unemployment rate remained very elevated and capacity utilization low, the pace of job losses had slowed noticeably since the summer, and industrial production had sustained the broad-based expansion that began in the third quarter. Consumer spending expanded solidly in October. Sales of new homes had risen in October after two months of little change, while sales of existing homes continued to increase strongly. Financial market conditions were generally regarded as having become more supportive of continued economic recovery during the intermeeting period. A jump in energy prices pushed up headline inflation somewhat, but core consumer price inflation remained subdued. Although some of the recent data had been better than anticipated, policymakers generally saw the incoming information as broadly in line with their expectations for a moderate economic recovery and subdued inflation. Consistent with experience following previous financial crises here and abroad, FOMC participants broadly anticipated that the pickup in output and employment would be rather slow relative to past recoveries from deep recessions.

The Committee made no changes to either its large-scale asset purchase programs or its target range for the federal funds rate of 0 to ¼ percent and, based on the outlook for a relatively sluggish economic recovery, decided to reiterate its anticipation that economic conditions, including low levels of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low rates for an extended period. Committee members and Board members agreed that substantial improvements in the functioning of financial markets had occurred; accordingly, they agreed that the statement to be released following the meeting should note the anticipated expiration of most of the Federal Reserve's special liquidity facilities on February 1, 2010.

At the January 26–27 meeting, the Committee agreed that the incoming information, though mixed, indicated that overall economic activity had strengthened in recent months, about as expected. Consumer spending was well maintained in the fourth quarter, and business expenditures on equipment and software appeared to expand substantially. However, the improvement in the housing market slowed, and spending on nonresidential structures continued to fall. Recent data suggested that the pace of inventory liquidation diminished considerably last quarter, providing a sizable boost to economic activity. Indeed, industrial production advanced at a solid rate in the fourth quarter. In the labor market, layoffs subsided noticeably in the final months of last year, but the unemployment rate remained elevated and hiring stayed quite limited. The weakness in labor markets continued to be an important concern for the Committee; moreover, the prospects for job growth remained a significant source of uncertainty in the economic outlook, particularly in the outlook for consumer spending. Financial market conditions were supportive of economic growth. However, net debt financing by nonfinancial businesses was near zero in the fourth quarter after declining in the third, consistent with sluggish demand for credit and tight credit standards and terms at banks. Increases in energy prices pushed up headline consumer price inflation even as core consumer price inflation remained subdued.

In their discussion of monetary policy for the period ahead, the Committee agreed that neither the economic outlook nor financial conditions had changed appreciably since the December meeting and that no changes to the Committee's large-scale asset purchase programs or to its target range for the federal funds rate of 0 to ¼ percent were warranted at this meeting. Further, policymakers reiterated their anticipation that economic conditions, including low levels of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low rates for an extended period. The Committee affirmed its intention to purchase a total of $1.25 trillion of agency MBS and about $175 billion of agency debt by the end of the current quarter and to gradually slow the pace of these purchases to promote a smooth transition in markets. Committee members and Board members agreed that with substantial improvements in most financial markets, including interbank markets, the statement would indicate that on February 1, 2010, the Federal Reserve was closing several special liquidity facilities and that the temporary swap lines with foreign central banks would expire. In addition, the statement would say that the Federal Reserve was in the process of winding down the TAF and that the final auction would take place in March 2010.

On February 1, 2010, given the overall improvement in funding markets, the Federal Reserve allowed the Primary Dealer Credit Facility, the Term Securities Lending Facility, the Commercial Paper Funding Facility, and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility to expire. The temporary swap lines with foreign central banks were closed on the same day. On February 18, 2010, the Federal Reserve announced a further normalization of the terms of loans made under the primary credit facility: The rate charged on these loans was increased from ½ percent to ¾ percent, effective on February 19, and the typical maximum maturity for such loans was shortened to overnight, effective on March 18, 2010. On the same day, the Federal Reserve also announced that the minimum bid rate on the final TAF auction on March 8 had been raised to 50 basis points, ¼ percentage point higher than in previous auctions. The Federal Reserve noted that the modifications are not expected to lead to tighter financial conditions for households and businesses and do not signal any change in the outlook for the economy or for monetary policy.

Over the course of 2009, the Federal Reserve continued to undertake initiatives to improve communications about its policy actions. These initiatives are described in detail in the box "Federal Reserve Initiatives to Increase Transparency."

Monetary Policy as the Economy Recovers

The actions taken by the Federal Reserve to support financial market functioning and provide extraordinary monetary stimulus to the economy have led to a rapid expansion of the Federal Reserve's balance sheet, from less than $900 billion before the crisis began in 2007 to about $2.3 trillion currently. The expansion of the Federal Reserve's balance sheet has been accompanied by a comparable increase in the quantity of reserve balances held by depository institutions. Bank reserves are currently far above their levels prior to the crisis. Even though, as noted in recent statements of the FOMC, economic conditions are likely to warrant exceptionally low rates for an extended period, in due course, as the expansion matures, the Federal Reserve will need to begin to tighten monetary conditions to prevent the development of inflation pressures. That tightening will be accomplished partly through changes that will affect the composition and size of the Federal Reserve's balance sheet. Eventually, the level of reserves and the size

of the Federal Reserve's balance sheet will be reduced substantially.

The Federal Reserve has a number of tools that will enable it to firm the stance of policy at the appropriate time and to the appropriate degree, some of which do not affect the size of the balance sheet or the quantity of reserves. Most importantly, in October 2008 the Congress gave the Federal Reserve statutory authority to pay interest on banks' holdings of reserve balances at Federal Reserve Banks. By increasing the interest rate paid on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates, because banks will not supply short-term funds to the money markets at rates significantly below what they can earn by simply leaving funds on deposit at the Federal Reserve Banks. Actual and prospective increases in short-term interest rates will be reflected, in turn, in longer-term interest rates and in financial conditions more generally through standard transmission mechanisms, thus preventing inflationary pressures from developing.

The Federal Reserve has also been developing a number of additional tools that will reduce the quantity of reserves held by the banking system and lead to a tighter relationship between the interest rate that the Federal Reserve pays on banks' holdings of reserve balances and other short-term interest rates. Reverse repurchase agreements (reverse repos) are one such tool; in a reverse repo, the Federal Reserve sells a security to a counterparty with an agreement to repurchase it at some specified date in the future. The counterparty's payment to the Federal Reserve has the effect of draining an equal quantity of reserves from the banking system. Recently, by developing the capacity to conduct such transactions in the triparty repo market, the Federal Reserve has enhanced its ability to use reverse repos to absorb very large quantities of reserves. The capability to carry out these transactions with primary dealers, using the Federal Reserve's holdings of Treasury and agency debt securities, has already been tested and is currently available if and when needed. To further increase its capacity to drain reserves through reverse repos, the Federal Reserve is also in the process of expanding the set of counterparties with which it can transact and is developing the infrastructure necessary to use its MBS holdings as collateral in these transactions.

As a second means of draining reserves, the Federal Reserve is also developing plans to offer to depository institutions term deposits, which are roughly analogous to certificates of deposit that the institutions offer to their customers. The Federal Reserve would likely offer large blocks of such deposits through an auction mechanism. The effect of these transactions would be to convert a portion of depository institutions' holdings of reserve balances into deposits that could not be used to meet depository institutions' very short-term liquidity needs and could not be counted as reserves. The Federal Reserve published in the *Federal Register* a proposal for such a term deposit facility and is in the process of reviewing the public comments received. After a revised proposal is approved by the Board, the Federal Reserve expects to be able to conduct test transactions in the spring and to have the facility available if necessary shortly thereafter. Reverse repos and the deposit facility would together allow the Federal Reserve to drain hundreds of billions of dollars of reserves from the banking system quite quickly should it choose to do so.

The Federal Reserve also has the option of redeeming or selling securities as a means of applying monetary restraint. A reduction in securities holdings would have the effect of further reducing the quantity of reserves in the banking system as well as reducing the overall size of the Federal Reserve's balance sheet. It would likely also put at least some direct upward pressure on longer-term yields.

The Treasury's temporary Supplementary Financing Program (SFP)—through which the Treasury issues Treasury bills to the public and places the proceeds in a special deposit account at the Federal Reserve—could also be used to drain reserves and support the Federal Reserve's control of short-term interest rates. However, the use of the SFP must be compatible with the Treasury's debt-management objectives. The SFP is not a necessary element in the Federal Reserve's set of tools to achieve an appropriate monetary policy stance in the future; still, any amount outstanding under the SFP will result in a corresponding decrease in the quantity of reserves in the banking system, which could be helpful in the Federal Reserve's conduct of policy.

The exact sequence of steps and combination of tools that the Federal Reserve chooses to employ as it exits from its current very accommodative policy stance will depend on economic and financial developments. One possible trajectory would be for the Federal Reserve to continue to test its tools for draining reserves on a limited basis in order to further ensure preparedness and to give market participants a period of time to become familiar with their operation. As the time for the removal of policy accommodation draws near, those operations could be scaled up to drain more-significant volumes of reserve balances to provide tighter control over short-term interest rates. The actual firming of policy would then be implemented through an increase in the interest rate paid on reserves. If economic and

Federal Reserve Initiatives to Increase Transparency

Transparency is a key tenet of modern central banking both because it contributes importantly to the accountability of central banks to the government and the public and because it can enhance the effectiveness of central banks in achieving their macroeconomic objectives. In recognition of the importance of transparency, the Federal Reserve has provided detailed information on the nontraditional policy actions taken to address the financial crisis, and generally aims to maximize the amount of information it can provide to the public consistent with its broad policy objectives.

The Federal Reserve has significantly enhanced its transparency in a number of important dimensions over recent years. On matters related to the conduct of monetary policy, the Federal Reserve has long been one of the most transparent central banks in the world. Following each of its meetings, the Federal Open Market Committee (FOMC) releases statements that provide a rationale for the policy decision, along with a record of the Committee's vote and explanations for any dissents. In addition, detailed minutes of each FOMC meeting are made public three weeks following the meeting. The minutes provide a great deal of information about the range of policymakers' views on the economic situation and outlook as well as on their deliberations about the appropriate stance of monetary policy. Recently, the Federal Reserve further advanced transparency by initiating a quarterly Summary of Economic Projections of Federal Reserve Board members and Reserve Bank presidents. These projections and the accompanying summary analysis contain detailed information regarding policymakers' views about the future path of real gross domestic product, inflation, and unemployment, including the long-run values of these variables assuming appropriate monetary policy.[1]

During the financial crisis, the Federal Reserve implemented a number of credit and liquidity programs to support the functioning of key financial markets and institutions and took complementary steps to ensure appropriate transparency and accountability in operating these programs. The Board's weekly H.4.1 statistical release has been greatly expanded to provide detailed information on the Federal Reserve's balance sheet and the operation of the various credit and liquidity facilities.[2] The release is closely watched in financial markets and by the public for nearly real-time information on the evolution of the Federal Reserve's balance sheet.

The Federal Reserve also developed a public website focused on its credit and liquidity programs that provides background information on all the facilities.[3] In addition, starting in December 2008 the Federal Reserve has issued bimonthly reports to the Congress in fulfillment of section 129 of the Emergency Economic Stabi-

1. FOMC statements and minutes, the Summary of Economic Projections, and other related information are available on the Federal Reserve Board's website. See Board of Governors of the Federal Reserve System, "Federal Open Market Committee," webpage, www.federalreserve.gov/monetarypolicy/fomc.htm.

2. Board of Governors of the Federal Reserve System, Statistical Release H.4.1, "Factors Affecting Reserve Balances," webpage, www.federalreserve.gov/releases/h41

3. Board of Governors of the Federal Reserve System, "Credit and Liquidity Programs and the Balance Sheet," webpage, www.federalreserve.gov/monetarypolicy/bst.htm.

financial developments were to require a more rapid exit from the current highly accommodative policy, however, the Federal Reserve could increase the interest rate on reserves at about the same time it commences draining operations.

The Federal Reserve currently does not anticipate that it will sell any of its securities holding in the near term, at least until after policy tightening has gotten under way and the economy is clearly in a sustainable recovery. However, to help reduce the size of its balance sheet and the quantity of reserves, the Federal Reserve is allowing agency debt and MBS to run off as they mature or are prepaid. The Federal Reserve is rolling over all maturing Treasury securities, but in the future it might decide not to do so in all cases. In the long run, the Federal Reserve anticipates that its balance sheet will shrink toward more historically normal levels and that most or all of its securities holdings will be Treasury securities. Although passively redeeming agency debt and MBS as they mature or are prepaid will move the Federal Reserve in that direction, the Federal Reserve may also choose to sell securities in the future when the economic recovery is sufficiently advanced and the FOMC has determined that the associated financial tightening is warranted. Any such sales would be gradual, would be clearly communicated to market participants, and would entail appropriate consideration of economic conditions.

lization Act of 2008; in October 2009, the Federal Reserve began incorporating these reports into its monthly report on credit and liquidity programs and the balance sheet.[4] The monthly report, which is available on the Federal Reserve's website, provides more-detailed information on the full range of credit and liquidity programs implemented during the crisis. This report includes data on the number and types of borrowers using various facilities and on the types and value of collateral pledged; information on the assets held in the so-called Maiden Lane facilities—created to acquire certain assets of The Bear Stearns Companies, Inc., and of American International Group, Inc. (AIG)—and in other special lending facilities; and quarterly financial statements for the Federal Reserve System. Furthermore, the monthly reports provide detailed information on all of the programs that rely on emergency lending authorities, including the Federal Reserve's assessment of the expected cost to the Federal Reserve and the U.S. taxpayer of various Federal Reserve programs implemented during the crisis. To provide further transparency regarding its transactions with AIG, the Federal Reserve recently indicated that it would welcome a full review by the Government Accountability Office of all aspects of the Federal Reserve's involvement with the extension of credit to AIG.[5]

The Federal Reserve has also been transparent about the management of its programs. Various programs employ private-sector firms as purchasing and settlement agents and to perform other functions; the contracts for all of these vendor arrangements are available on the website of the Federal Reserve Bank of New York.[6] Moreover, the Federal Reserve has recently begun to publish detailed CUSIP-number-level data regarding its holdings of Treasury, agency, and agency mortgage-backed securities; these data provide the public with precise information about the maturity and asset composition of the Federal Reserve's securities holdings.[7] On January 11, 2010, the Federal Reserve Bank of New York published a revised policy governing the designation of primary dealers.[8] An important motivation in issuing revised guidance in this area was to make the process for becoming a primary dealer more transparent.

4. Board of Governors of the Federal Reserve System, ***Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet*** (Washington: Board of Governors).

5. Ben S. Bernanke (2010), letter to Gene L. Dodaro, January 19, www.federalreserve.gov/monetarypolicy/files/letter_aig_20100119.pdf.

6. Federal Reserve Bank of New York, "Vendor Information," webpage, www.newyorkfed.org/aboutthefed/vendor_information.html.

7. Federal Reserve Bank of New York, "System Open Market Account Holdings," webpage, www.newyorkfed.org/markets/soma/sysopen_accholdings.html.

CUSIP is the abbreviation for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including stocks of all registered U.S. and Canadian companies and U.S. government and municipal bonds. The CUSIP system—owned by the American Bankers Association and operated by Standard & Poor's—facilitates the clearing and settlement process of securities.

8. Federal Reserve Bank of New York (2010), "New York Fed Publishes Revised Policy for Administration of Primary Dealer Relationships," press release, January 11, www.newyorkfed.org/newsevents/news/markets/2010/ma100111.html.

As a result of the very large volume of reserves in the banking system, the level of activity and liquidity in the federal funds market has declined considerably, raising the possibility that the federal funds rate could for a time become a less reliable indicator than usual of conditions in short-term money markets. Accordingly, the Federal Reserve is considering the utility, during the transition to a more normal policy configuration, of communicating the stance of policy in terms of another operating target, such as an alternative short-term interest rate. In particular, it is possible that the Federal Reserve could for a time use the interest rate paid on reserves, in combination with targets for reserve quantities, as a guide to its policy stance, while simultaneously monitoring a range of market rates. No decision has been made on this issue, and any deliberation will be guided in part by the evolution of the federal funds market as policy accommodation is withdrawn. The Federal Reserve anticipates that it will eventually return to an operating framework with much lower reserve balances than at present and with the federal funds rate as the operating target for policy.

Part 4
Summary of Economic Projections

The following material appeared as an addendum to the minutes of the January 26–27, 2010, meeting of the Federal Open Market Committee.

In conjunction with the January 26–27, 2010, FOMC meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in deliberations of the FOMC, submitted projections for output growth, unemployment, and inflation for the years 2010 to 2012 and over the longer run. The projections were based on information available through the end of the meeting and on each participant's assumptions about factors likely to affect economic outcomes, including his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future path of policy that the participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her interpretation of the Federal Reserve's dual objectives of maximum employment and stable prices. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

FOMC participants' forecasts for economic activity and inflation were broadly similar to their previous projections, which were made in conjunction with the November 2009 FOMC meeting. As depicted in figure 1, the economic recovery from the recent recession was expected to be gradual, with real gross domestic product (GDP) expanding at a rate that was only moderately above participants' assessment of its longer-run sustainable growth rate and the unemployment rate declining slowly over the next few years. Most participants also anticipated that inflation would remain subdued over this period. As indicated in table 1, a few participants made modest upward revisions to their projections for real GDP growth in 2010. Beyond 2010, however, the contours of participants' projections for economic activity and inflation were little changed, with participants continuing to expect that the pace of the economic recovery will be restrained by household and business uncertainty, only gradual improvement in labor market conditions, and slow easing of credit conditions in the banking sector. Participants generally expected that it would take some time for the economy to converge fully to its longer-run path—characterized by a sustainable rate of output growth and by rates of employment and inflation consistent with their interpretation of the Federal Reserve's dual objectives—with a sizable minority of the view that the convergence process could take more than five to six years. As in

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, January 2010

Percent

Variable	Central tendency[1]				Range[2]			
	2010	2011	2012	Longer run	2010	2011	2012	Longer run
Change in real GDP	2.8 to 3.5	3.4 to 4.5	3.5 to 4.5	2.5 to 2.8	2.3 to 4.0	2.7 to 4.7	3.0 to 5.0	2.4 to 3.0
November projection	2.5 to 3.5	3.4 to 4.5	3.5 to 4.8	2.5 to 2.8	2.0 to 4.0	2.5 to 4.6	2.8 to 5.0	2.4 to 3.0
Unemployment rate	9.5 to 9.7	8.2 to 8.5	6.6 to 7.5	5.0 to 5.2	8.6 to 10.0	7.2 to 8.8	6.1 to 7.6	4.9 to 6.3
November projection	9.3 to 9.7	8.2 to 8.6	6.8 to 7.5	5.0 to 5.2	8.6 to 10.2	7.2 to 8.7	6.1 to 7.6	4.8 to 6.3
PCE inflation	1.4 to 1.7	1.1 to 2.0	1.3 to 2.0	1.7 to 2.0	1.2 to 2.0	1.0 to 2.4	0.8 to 2.0	1.5 to 2.0
November projection	1.3 to 1.6	1.0 to 1.9	1.2 to 1.9	1.7 to 2.0	1.1 to 2.0	0.6 to 2.4	0.2 to 2.3	1.5 to 2.0
Core PCE inflation[3]	1.1 to 1.7	1.0 to 1.9	1.2 to 1.9		1.0 to 2.0	0.9 to 2.4	0.8 to 2.0	
November projection	1.0 to 1.5	1.0 to 1.6	1.0 to 1.7		0.9 to 2.0	0.5 to 2.4	0.2 to 2.3	

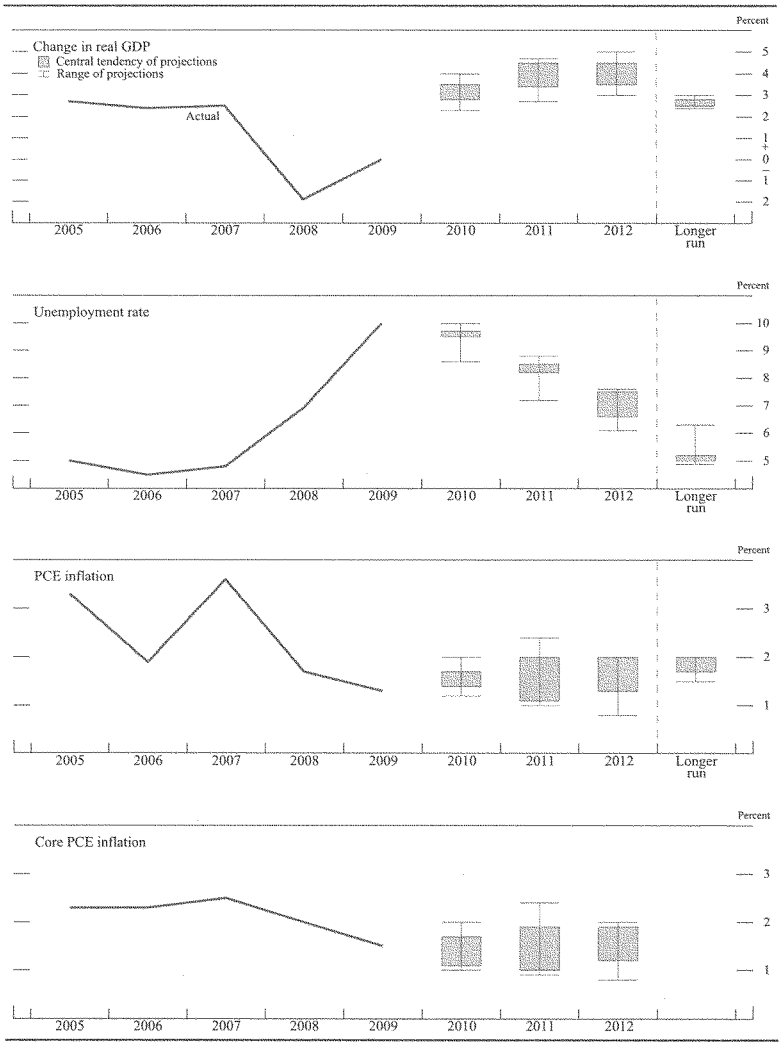
NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 3–4, 2009.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.

2. The range for a variable in a given year consists of all participants' projections, from lowest to highest, for that variable in that year.

3. Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2010–12 and over the longer run



NOTE: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual. The data for the change in real GDP, PCE inflation, and core PCE inflation shown for 2009 incorporate the advance estimate of GDP for the fourth quarter of 2009, which the Bureau of Economic Analysis released on January 29, 2010; this information was not available to FOMC meeting participants at the time of their meeting.

November, nearly all participants judged the risks to their growth outlook as generally balanced, and most also saw roughly balanced risks surrounding their inflation projections. Participants continued to judge the uncertainty surrounding their projections for economic activity and inflation as unusually high relative to historical norms.

The Outlook

Participants' projections for real GDP growth in 2010 had a central tendency of 2.8 to 3.5 percent, a somewhat narrower interval than in November. Recent readings on consumer spending, industrial production, and business outlays on equipment and software were seen as broadly consistent with the view that economic recovery was under way, albeit at a moderate pace. Businesses had apparently made progress in bringing their inventory stocks into closer alignment with sales and hence would be likely to raise production as spending gained further momentum. Participants pointed to a number of factors that would support the continued expansion of economic activity, including accommodative monetary policy, ongoing improvements in the conditions of financial markets and institutions, and a pickup in global economic growth, especially in emerging market economies. Several participants also noted that fiscal policy was currently providing substantial support to real activity, but said that they expected less impetus to GDP growth from this factor later in the year. Many participants indicated that the expansion was likely to be restrained not only by firms' caution in hiring and spending in light of the considerable uncertainty regarding the economic outlook and general business conditions, but also by limited access to credit by small businesses and consumers dependent on bank-intermediated finance.

Looking further ahead, participants' projections were for real GDP growth to pick up in 2011 and 2012; the projections for growth in both years had a central tendency of about 3½ to 4½ percent. As in November, participants generally expected that the continued repair of household balance sheets and gradual improvements in credit availability would bolster consumer spending. Responding to an improved sales outlook and readier access to bank credit, businesses were likely to increase production to rebuild their inventory stocks and increase their outlays on equipment and software. In addition, improved foreign economic conditions were viewed as supporting robust growth in U.S. exports. However, participants also indicated that elevated uncertainty on the part of households and businesses and the very slow recovery of labor markets would likely restrain the pace of expansion. Moreover, although conditions in the banking system appeared to have stabilized, distress in commercial real estate markets was expected to pose risks to the balance sheets of banking institutions for some time, thereby contributing to only gradual easing of credit conditions for many households and smaller firms. In the absence of further shocks, participants generally anticipated that real GDP growth would converge over time to an annual rate of 2.5 to 2.8 percent, the longer-run pace that appeared to be sustainable in view of expected demographic trends and improvements in labor productivity.

Participants anticipated that labor market conditions would improve only slowly over the next several years. Their projections for the average unemployment rate in the fourth quarter of 2010 had a central tendency of 9.5 to 9.7 percent, only a little below the levels of about 10 percent that prevailed late last year. Consistent with their outlook for moderate output growth, participants generally expected that the unemployment rate would decline only about 2½ percentage points by the end of 2012 and would still be well above its longer-run sustainable rate. Some participants also noted that considerable uncertainty surrounded their estimates of the productive potential of the economy and the sustainable rate of employment, owing partly to substantial ongoing structural adjustments in product and labor markets. Nonetheless, participants' longer-run unemployment projections had a central tendency of 5.0 to 5.2 percent, the same as in November.

Most participants anticipated that inflation would remain subdued over the next several years. The central tendency of their projections for personal consumption expenditures (PCE) inflation was 1.4 to 1.7 percent for 2010, 1.1 to 2.0 percent for 2011, and 1.3 to 2.0 percent for 2012. Many participants anticipated that global economic growth would spur increases in energy prices, and hence that headline PCE inflation would run slightly above core PCE inflation over the next year or two. Most expected that substantial resource slack would continue to restrain cost pressures, but that inflation would rise gradually toward their individual assessments of the measured rate of inflation judged to be most consistent with the Federal Reserve's dual mandate. As in November, the central tendency of projections of the longer-run inflation rate was 1.7 to 2.0 percent. A majority of participants anticipated that inflation in 2012 would still be below their assessments of the mandate-consistent inflation rate, while the remainder expected that inflation would be at or slightly above its longer-run value by that time.

Uncertainty and Risks

Nearly all participants shared the judgment that their projections of future economic activity and unemployment continued to be subject to greater-than-average uncertainty.[19] Participants generally saw the risks to these projections as roughly balanced, although a few indicated that the risks to the unemployment outlook remained tilted to the upside. As in November, many participants highlighted the difficulties inherent in predicting macroeconomic outcomes in the wake of a financial crisis and a severe recession. In addition, some pointed to uncertainties regarding the extent to which the recent run-up in labor productivity would prove to be persistent, while others noted the risk that the deteriorating performance of commercial real estate could adversely affect the still-fragile state of the banking system and restrain the growth of output and employment over coming quarters.

As in November, most participants continued to see the uncertainty surrounding their inflation projections as higher than historical norms. However, a few judged that uncertainty in the outlook for inflation was about in line with typical levels, and one viewed the uncertainty surrounding the inflation outlook as lower than average. Nearly all participants judged the risks to the inflation outlook as roughly balanced; however, two saw these risks as tilted to the upside, while one regarded the risks as weighted to the downside. Some participants noted that inflation expectations could drift downward in response to persistently low inflation and continued slack in resource utilization. Others pointed to the possibility of an upward shift in expected and actual inflation, especially if extraordinarily accommodative monetary policy measures were not unwound in a timely fashion. Participants also noted that an acceleration in global economic activity could induce a surge in the prices of energy and other commodities that would place upward pressure on overall inflation.

Diversity of Views

Figures 2.A and 2.B provide further details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate in 2010, 2011, 2012, and over the longer run. The distribution of participants' projections for real GDP growth this year was slightly narrower than the distribution of their projections last November, but the distributions of the projections for real GDP growth in 2011 and in 2012 were little changed. The dispersion in participants' output growth projections reflected, among other factors, the diversity of their assessments regarding the current degree of underlying momentum in economic activity, the evolution of consumer and business sentiment, and the likely pace of easing of bank lending standards and terms. Regarding participants' unemployment rate projections, the distribution for 2010 narrowed slightly, but the distributions of their unemployment rate projections for 2011 and 2012 did not change appreciably. The distributions of participants' estimates of the longer-run sustainable rates of output growth and unemployment were essentially the same as in November.

Figures 2.C and 2.D provide corresponding information about the diversity of participants' views regarding the inflation outlook. For overall and core PCE inflation, the distributions of participants' projections for 2010 were nearly the same as in November. The distributions of overall and core inflation for 2011 and 2012, however, were noticeably more tightly concentrated than in November, reflecting the absence of forecasts of especially low inflation. The dispersion in participants' projections over the next few years was mainly due to differences in their judgments regarding the determinants of inflation, including their estimates of prevailing resource slack and their assessments of the extent to which such slack affects actual and expected inflation. In contrast, the relatively tight distribution of

Table 2. Average historical projection error ranges

Percentage points

Variable	2010	2011	2012
Change in real GDP[1]	±1.3	±1.5	±1.6
Unemployment rate[1]	±0.6	±0.8	±1.0
Total consumer prices[2]	±0.9	±1.0	±1.0

NOTE: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1989 through 2008 that were released in the winter by various private and government forecasters. As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

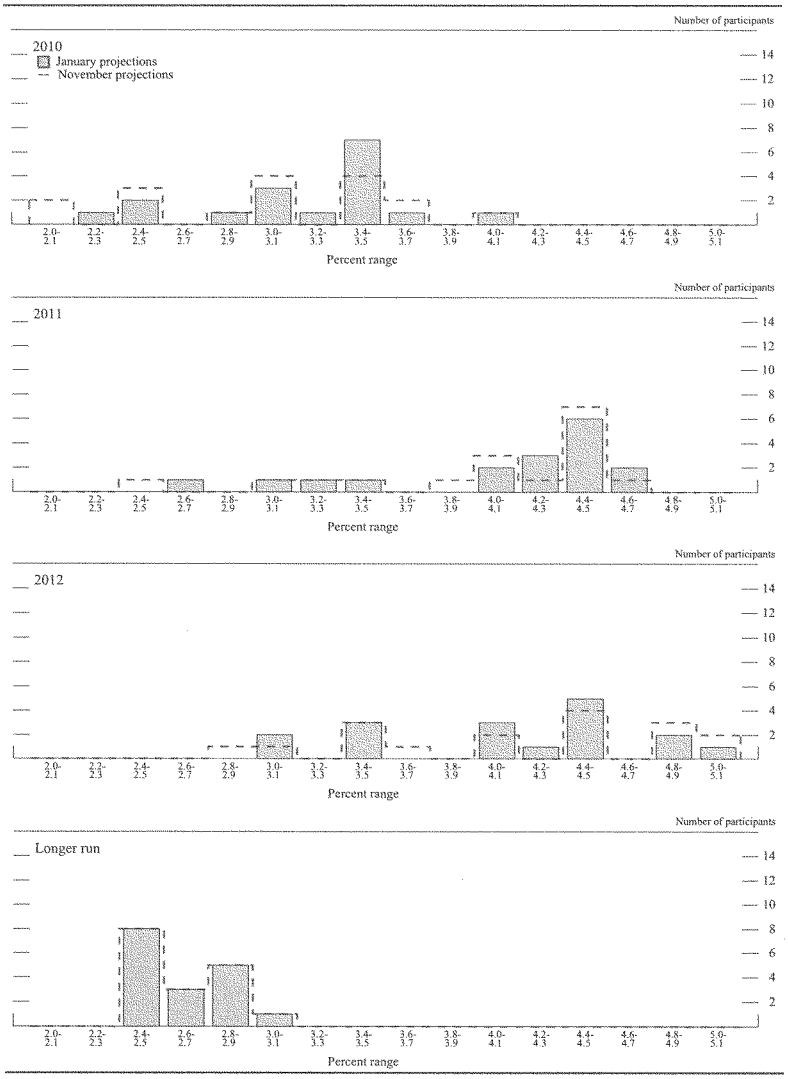
1. For definitions, refer to general note in table 1.

2. Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

19. Table 2 provides estimates of forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1989 to 2008. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in economic forecasts and explains the approach used to assess the uncertainty and risk attending participants' projections.

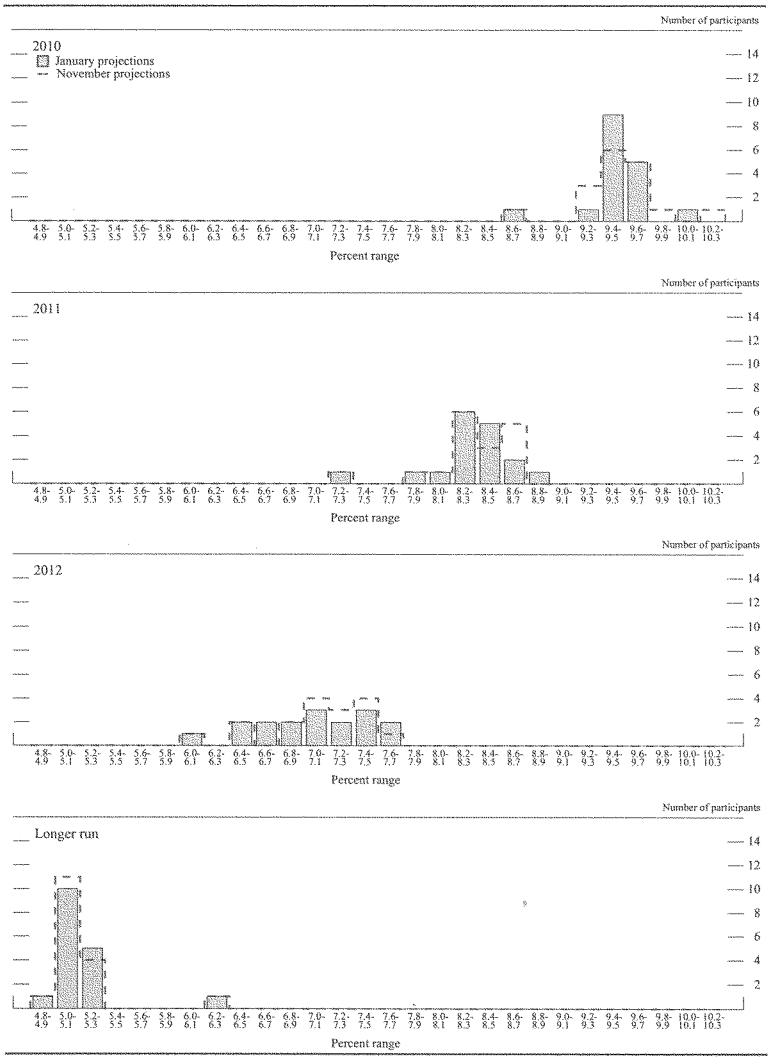
participants' projections for longer-run inflation illustrates their substantial agreement about the measured rate of inflation that is most consistent with the Federal Reserve's dual objectives of maximum employment and stable prices.

Figure 2.A. Distribution of participants' projections for the change in real GDP, 2010–12 and over the longer run



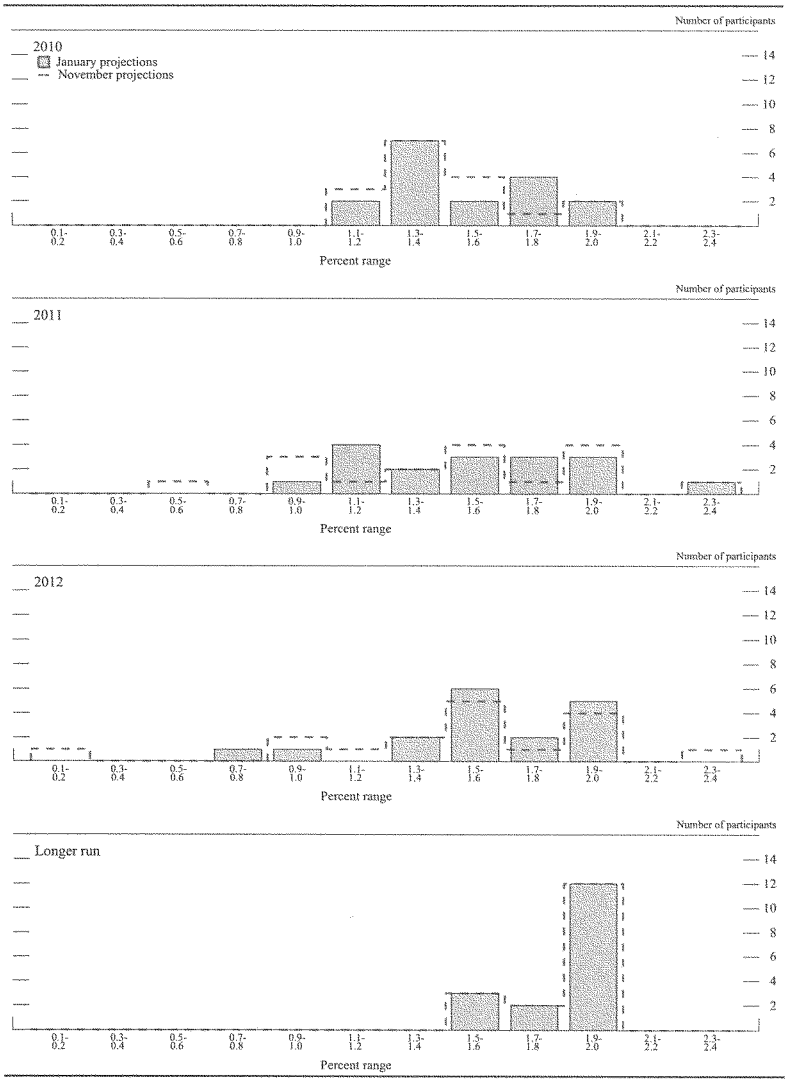
NOTE: Definitions of variables are in the general note to table 1.

Figure 2.B. Distribution of participants' projections for the unemployment rate, 2010–12 and over the longer run



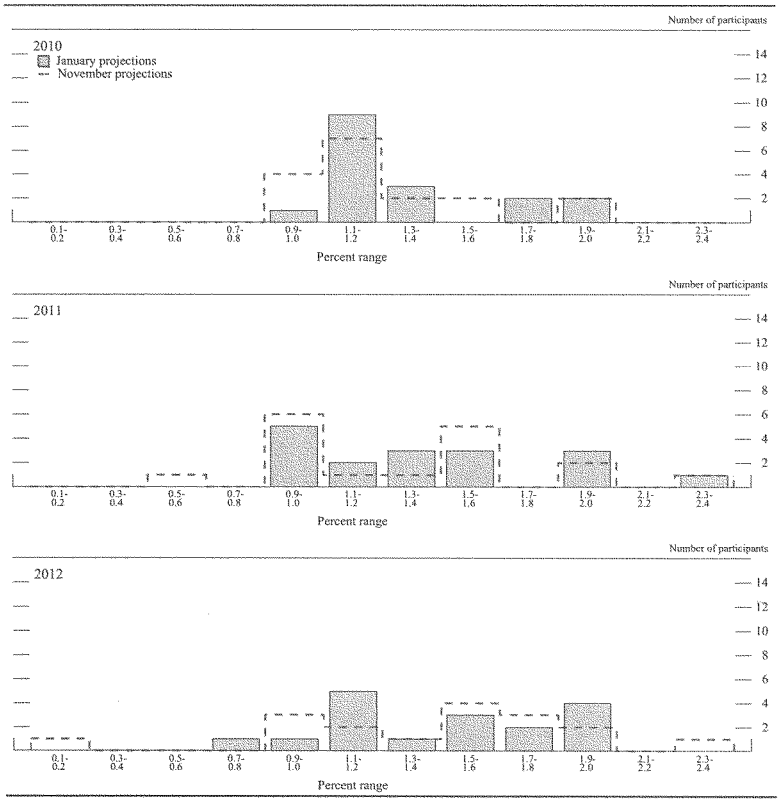
NOTE: Definitions of variables are in the general note to table 1.

Figure 2.C. Distribution of participants' projections for PCE inflation, 2010–12 and over the longer run



NOTE: Definitions of variables are in the general note to table 1.

Figure 2.D. Distribution of participants' projections for core PCE inflation, 2010–12



NOTE: Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world. And the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past ***Monetary Policy Reports*** and those prepared by Federal Reserve Board staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 1.7 to 4.3 percent in the current year, 1.5 to 4.5 percent in the second year, and 1.4 to 4.6 percent in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.1 to 2.9 percent in the current year and 1.0 to 3.0 percent in the second and third years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

Abbreviations

ABS	asset-backed securities
AIG	American International Group, Inc.
ARRA	American Recovery and Reinvestment Act
CDS	credit default swap
C&I	commercial and industrial
CMBS	commercial mortgage-backed securities
CRE	commercial real estate
Credit CARD Act	Credit Card Accountability Responsibility and Disclosure Act
CUSIP	Committee on Uniform Securities Identification Procedures
ECB	European Central Bank
E&S	equipment and software
FAS	Financial Accounting Standards
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FOMC	Federal Open Market Committee; also, the Committee
GDP	gross domestic product
GSE	government-sponsored enterprise
Libor	London interbank offered rate
LLC	limited liability company
MBS	mortgage-backed securities
NFIB	National Federation of Independent Business
NIPA	national income and product accounts
OIS	overnight index swap
PCE	personal consumption expenditures
repo	repurchase agreement
SCAP	Supervisory Capital Assessment Program
SFP	Supplementary Financing Program
SLOOS	Senior Loan Officer Opinion Survey on Bank Lending Practices
TAF	Term Auction Facility
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
TIPS	Treasury inflation-protected securities

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