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S. HRG. 110–697

THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

APRIL 2, 2008

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

44–455 PDF WASHINGTON : 2008

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) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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The Economic Outlook

WEDNESDAY, APRIL 2, 2008

CONGRESS OF THE UNITED STATES CONGRESS
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 9:30 a.m. in room SD–106 of the Dirksen Senate Office Building, The Honorable Charles E. Schumer (Chairman) presiding.

Senators present. Kennedy, Bingaman, Klobucher, Casey, Jr., Webb, Brownback, Sununu, and Bennett.

Representatives present. Maloney, Hinchey, Sanchez, Cummings, Doggett, Brady, and Paul.

Staff present. Christina Baumgardner, Heather Boushey, Anna Fodor, Tamara Fucile, Nan Gibson, Colleen Healy, Israel Klein, Michael Laskawy, Ted Boll, Chris Frenze, Bob Keleher, Tyler Kurtz, Robert O'Quinn, Rachel Greszler, Brian Larkin, Jeff Schlagenhauf, Christina Valentine and Jeff Wrase.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Chairman Schumer. The Committee will come to order.

Well, Chairman Bernanke, we want to thank you for joining us today, in what will be your third appearance at the Joint Economic Committee during this session, this term of Congress.

Of course, you're here to talk about the economy, not just housing, not just financial markets, and not just the regulation of those markets.

The economic news continues to be alarming, whether it's employment, inflation, housing, financial industry turmoil, or consumer confidence.

Last month, you looked over the precipice of financial meltdown and acted. It is hard to disagree with the need to take quick and dramatic action to spare our financial system from the risk of the kind of meltdown we saw in the Great Depression.

Those who, in retrospect, say they wouldn't have acted, in my judgment, are showing an unfortunate degree of intellectual arrogance and maybe even some disingenuousness.

To look into the abyss of imminent financial collapse as a potential and do nothing is irresponsible.

Your actions to rescue Bear Stearns provided some much needed breathing room to the financial markets for now, but there are many legitimate, looming, and unanswered questions about the "before" and the "after."

What happened, both before and after the Bear Stearns action? On the "before," as early as last Summer, there were warning signs that Bear Stearns was in trouble, when two of Bear's hedge funds, funds that were heavily invested in subprime mortgages, were forced to declare bankruptcy.

At that time, were the members of the Fed concerned about the long-term viability of Bear Stearns? Did you receive any consultation from other agencies, like the SEC?

If you were concerned, did you take any actions behind the scenes to help shore up Bear's tenuous position, and if not, at what point did you know that Bear Stearns was in serious jeopardy? What action did you take at that point?

Could earlier, more aggressive action by the Fed, by the SEC, or some other agency, have saved Bear?

And the "after"—in the wake of the Bear Stearns debacle, a number of concerns have been raised about the precedent that the Fed's actions set for other Wall Street firms. In order to avoid a similar future situation, what actions has the Fed taken to deal with a possible similar situation?

Do you now have established criteria for when intervention is appropriate? To avoid a future Bear Stearns situation, do you expect the Fed and the SEC to be more proactive in protecting investors from a potential Bear-like situation?

Now, maybe if we had a single financial regulator, this wouldn't have happened. Imagine how much better off we would have been if there were a strong regulator who could have called in Bear Stearns far earlier and forced them to take steps that would have prevented the disaster we confronted 2 weeks ago. How much better off we would be?

And there are serious questions about housing, as well, and many people juxtapose the action that was taken in regard to Bear, and then not taken in regard to housing. What is the justice of helping Bear Stearns and not millions of homeowners?

A single homeowner going under does not pose systemic risks, as Bear did, but millions of homeowners going under do.

I worry that, as quickly as the Federal Government moved to save Bear Stearns from complete failure, it has moved at a snail's pace, if at all, to save homeowners from foreclosures.

The Administration was all for Government action in the case of Bear Stearns, but what about Government action to help homeowners? Yes, Bear Stearns was in trouble, but millions of homeowners are also in trouble.

Yes, Bear Stearns needed Government intervention, but what about Government intervention for homeowners?

I'm hopeful that this week the Senate will redouble its efforts to respond to the housing crisis by passing much needed legislation. And while I know that you don't take positions on specific legislation—no Fed Chairman does and Fed Chairmen shouldn't, in my opinion—I hope that you will privately use your influence to convince those in the Administration that this modest effort is needed to bolster homeowners and the economy.

We will hopefully get bipartisan support for the Foreclosure Prevention Act, which, among other things, would add $200 million in pre-foreclosure counselling funds, which could help 500,000 fami-

lies keep their homes and strengthen the housing markets and the economy, and provide $4 billion in community development block grant funds for the purchase and rehab of foreclosed properties, so that property values, particularly those in certain areas afflicted by foreclosure, don't decline even more precipitously than they have already.

Beyond the immediate response demanded for the housing crisis, it is now also crystal clear that we must rethink the regulatory framework that governs our financial system.

Over the past decade, consolidation has become the norm in the financial industry. There are no longer distinct commercial banks, investment banks, broker/dealers, traders, insurers; instead, there are a large number of financial institutions offering a constellation of financial products, surrounded by many smaller institutions, such as hedge funds and private equity funds with their own specialties.

It's as though we have a handful of large financial Jupiters that are becoming more and more similar, encircled by numerous small asteroids. The U.S. financial regulatory system is still based on the crisis we responded to in the 1920s and 1930s, not on the 21st Century financial institutions we have now.

We want entrepreneurial vigor in our system, and overregulation can stifle that, but we also need robust regulation, particularly to guard against systemic risks.

I said this week that Secretary Paulson's blueprint is a good foundation for updating the regulation of U.S. markets, but it leaves much to be desired, and, most importantly, doesn't address the housing and economic crisis we face right now.

If we focus only on the consolidation of regulatory bodies, and also don't adopt a careful, but more pro-regulation approach, then we will have approached this modernizing task with a pre-Bear Stearns mindset.

I believe there are six principles that we should follow as we re-regulate:

First, we must focus on controlling systemic risk.

Second, we need to look closely at unifying and simplifying our regulatory structure, perhaps moving toward a single regulator.

Third, we must figure out how to regulate the currently unregulated parts of financial markets, especially opaque and complex financial instruments that now put the entire system at risk.

Fourth, we must recognize that a global financial world requires global solutions.

Fifth, we must have greater transparency; and,

Sixth, the laissez-faire view that predominates in this Administration, far greater than it did under Ronald Reagan or George Bush, Sr., has to change. Regulators ought to regulate.

I hope that you'll use your position to jawbone this Administration to get behind the housing relief effort before Congress this week. They have not committed to it.

Addressing the housing crisis head-on will do as much to instill confidence in the markets as lowering interest rates or bolstering regulatory oversight of wayward mortgage lenders and financial institutions. We need to do all of it. Thank you, Mr. Chairman.

[The prepared statement of Senator Schumer appears in the Submissions for the Record on page 56.]

Chairman Schumer. Now, normally, I encourage all of our Members to make opening statements, but because you only have limited time and we have many, many questions, I am going to ask only our Vice Chair and the Senate and House Ranking Members, that is usually Representative Saxton, but today, Congressman Brady will take his place, and Senator Brownback, to make opening remarks.

Other Members may submit their full statements into the record and can use their question time as they wish.

Chairman Schumer. Let me now call on my colleague, Senator Brownback, for an opening statement.

OPENING STATEMENT OF HON. SAM BROWNBACK, A U.S. SENATOR FROM KANSAS

Senator Brownback. Thank you very much, Mr. Chairman, I appreciate that. Welcome, Chairman Bernanke. I look forward to the question-and-answer time period.

I think I, along with everybody else, was stunned with the action that took place, although very appreciative of it. But I'd like to know a lot more details about what took place, the thinking process, the decisionmaking process, and then the likelihood for this leading to future actions.

I guess that's really the thing that I would like to know more than anything. Does this set the precedent for what we're going to be doing in the future, when you get institutions of this size and scale, getting involved in problems?

So I really want to examine that with you, as well. We'll have some questions and philosophical concerns over the actions taken by the Federal Reserve in conjunction with Bear Stearns.

Based upon what I know, it appears that the Federal Reserve's swift and decisive actions were both appropriate and necessary. Chairman Bernanke, thank you for your strong and decisive leadership.

I do not believe there is a single Member of this Committee, who does not recognize that liquid and properly functioning financial markets are critical to the Nation's economic future.

While news of the events unfolded at Bear Stearns, your response at the Federal Reserve and the markets' response to those actions, and Treasury's proposal to revamp the financial sector's regulatory structure provided a stark reminder of how important confidence in markets is to their efficient operation.

And recent events provide a warning as to how fragile markets become, when confidence evaporates.

There's been a great deal of fingerpointing as to who is to blame for the current situation, whether it's unscrupulous mortgage brokers or dishonest situations all around, or incompetent actions by rating agencies, irresponsible speculators, investment bankers; but putting aside the fingerpointing for a moment, it appears to me that the failure to quantify accurately the true risk of highly leveraged transactions lies at the epicenter of what we've seen in this current situation.

Unfortunately, there doesn't appear to be a particularly good learning curve on our part, associated with financial crises, and you can go back through multiple Administrations, multiple Chairmen, to look at this.

Look at the popping of the dot.com bubble in the 1990s; the stock market plunge in October 1987; the S&L crisis in 1980; Continental Illinois, before that, and on and on. And it just seems like in each case, the euphoria of good times would appear to not adequately acknowledge what seems to be improbable outcomes, can actually arise.

We seem not to adequately protect against the risks of these improbable events coming to fruition, resulting in very large losses.

I do not think that you can always spot speculative excesses that lead to asset price bubbles, but when we observe things like escalator clauses in real estate contracts and no-documentation mortgage lending, we should start to get concerned.

I fear that regulators, in the euphoria of good times, simply fell asleep at the wheel. We describe the real estate market as being characterized by pockets of froth, but what turned out to be gambles on real estate prices ended up influencing the financial stability of our Nation's financial system.

That's what's so interesting, I guess, to me is how this then leads to where we are today.

I find that the Fed accommodated financing for the acquisition of Bear Stearns because that company effectively faced a crisis of confidence, and a claimant staged to run on the institution.

Evidently, the Fed deemed Bear Stearns as too big to send to bankruptcy for fear of threats to the systemic stability of the Nation's financial system.

If the Federal Reserve is going to take private-sector assets onto its balance sheet, I would hope that we at least have the Fed and others monitoring what the people who bought those assets were doing.

If private institutions engage in highly leveraged bets and those bets turn out to go sour, we're putting U.S. taxpayer funds at risk. When the Fed ends up effectively guaranteeing some or all of the value of those bets, if that's what we're going to do, then don't we at least need oversight into what bets are allowable?

With the advent of hedge funds, off-balance-sheet financial entities, sovereign wealth funds, and the like, whose bets are we willing to back?

I think these are very important public policy questions that we need to have some definition on the answers, if the world is to have faith that the promises made in U.S. financial markets will be honored without imposing undue risk from rogue speculators.

You have a lot of smart people working at the Federal Reserve. I am concerned when the taxpayer's money becomes the skin in the game to rescue supposedly sophisticated investment and commercial banks from the results of their own poor decisionmaking.

I am extremely interested in learning more about what processes the Federal Reserve will utilize to quantify the financial risk to the taxpayer, resulting from the Fed's $29 billion backstop to the Bear Stearns-J.P. Morgan marriage.

As the Federal Reserve continues to study the meltdown in the subprime mortgage market, I hope that you will undertake an evaluation of the degree to which the failure to implement quality control standards on mortgage originating activity contributed to that current crisis.

Specifically, I'd like the Federal Reserve to determine if instituting a system of rating originators for the completeness and accuracy of the data they provide lenders and making that part of the loan's rating would, based on an evaluation of real-world data, have prevented some of these loans from being made or from being scrutinized.

From my perspective, this would add exactly the kind of transparency and more granular information called for in the President's Working Group report.

The essence of meaningful quality control and risk management, is to constantly test those systems for material weaknesses.

As you know, the housing—the Senate is considering housing legislation. One of those issues coming up is amending the Bankruptcy Code to allow Bankruptcy Courts to amend the terms of the mortgages on principal residence. I'm interested, from your perspective—if you're willing to comment—the impact you think that may have on the financial markets and mortgage-backed securities.

And on another note, I'd like to express for the record, my continued concern over the Senate's failure to give you a full complement of Federal Reserve Governors, and the President, a full Council of Economic Advisors at this critical juncture for our economy.

Mr. Chairman, I thank you for being here. I thank the Chairman for scheduling this hearing. I look forward to the testimony and exchange of questions.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 58.]

Chairman Schumer. Thank you, Senator Brownback.

Vice Chair Maloney.

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, VICE CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Vice Chair Maloney. Good morning and thank you, Chairman Schumer, for scheduling this hearing, and welcome, Chairman Bernanke.

Yesterday, Speaker Pelosi called on the President to join in a bipartisan economic summit to focus on the kitchen-table concerns of American families. At this moment in history, we need to come together to solve our Nation's serious economic challenges.

The Bush administration's blueprint for regulatory reform is a distraction from the problems at hand. Even if the plan were put into place today, it would make no difference in the current crisis.

Our regulatory system is in serious need of renovation because financial innovation has surpassed our ability to protect consumers and hold institutions accountable.

But we should not rush to revamp our regulatory system until we are sure we understand the problems. As former Treasury Secretary Larry Summers recently observed, it's probably a bad idea to spend too much time debating the organization of the fire department while the fire is still burning.

We should, instead, move quickly to keep families in their homes, and blunt the devastating effects of the weakening economy.

The decline in home prices is causing banks to readjust their balance sheets and to buildup capital, which is at the core of the liquidity crisis.

Economists warn that continuing financial volatility will be difficult until housing prices stop falling, which is why Congress is working on solutions to keep people in their homes and to avoid a deep downturn.

Representative Frank and Senators Dodd and Shelby have proposed a $300 billion loan guarantee program through the Federal Housing Administration, which would allow the nearly 9 million homeowners with negative equity to refinance their mortgages at reasonable rates.

And for homes already in foreclosure, another measure would make $10 billion available in grants and loans to States to buy foreclosed properties and to allow families to either buy or rent them.

The crisis in the housing market has brought to light the inability of our most sophisticated and respected institutions to measure their exposure to opaque assets, and more importantly, to manage the risks associated with them.

To underscore this challenge, my respected constituent, former Treasury Secretary Robert Ruben, recently said that he had not even heard of liquidity puts—an obscure kind of financial contract—until they started causing big, big problems with Citigroup.

I hope we will hear from Chairman Bernanke about what we should be doing to increase transparency for complex investment products, to assure smoothly functioning markets.

In recent weeks, we've heard calls for the Fed to oversee risk across the broad financial spectrum, and I know we are all anxious to hear your thoughts on this.

In order to forestall a meltdown of the financial sector, the Fed has recently employed some creative, unprecedented, and controversial steps to ease the credit crunch, which have come to resemble the spontaneous improvisation of jazz.

I hope that Chairman Bernanke's respected academic research prior to joining the Fed, will help us avoid repeating the mistakes of the Great Depression. Clearly, we are in uncharted territory.

The Fed has recently come under fire for making a $29 billion line of credit available to J.P. Morgan Chase to acquire the investment giant Bear Stearns.

This action to head off a sudden collapse of one of the Nation's largest investment banks, very likely prevented widespread financial panic and a potential domino effect among other financial institutions.

Wall Street has been helped, and now it's time to help Main Street. We should take this moment in history to build on the stimulus plan, by considering additional measures to strengthen the economy.

It is most likely too late to avoid the second economic downturn of President Bush's administration, but it is not too late for the Administration to work with Congress to prevent families from losing

their homes, put people back to work, and restore confidence in the American economy.

Mr. Chairman, I thank you for this hearing, and thank you, Mr. Bernanke, for your service and for testifying for the third time before our Committee.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 60.]

Chairman Schumer. Thank you, Vice Chair Maloney. Now, Congressman Brady.

Representative Brady. Thank you, Mr. Chairman. I'm anxious to get to questions, so I would ask unanimous consent to submit my statement for the record.

Chairman Schumer. Without objection.

OPENING STATEMENT OF HON. KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you. Let me just summarize two points that obviously the events of recent weeks have made it very clear that a major reform of financial regulation is needed, as noted by Secretary Paulson.

The current structure of financial regulation dates back to the 1930s, and doesn't reflect the financial innovation that's occurred in recent decades, if not recent years.

Some streamlining and consolidation obviously is needed, whether or not one agrees entirely with every detail in the new Treasury proposal for financial regulatory reform.

I think that in this time of financial instability and uncertainty, the Fed has taken important steps to respond in a way that improves the prospects for economic growth.

Congress, I think, has made some contribution by enacting this economic stimulus legislation, and while I am skeptical it will help, I am hopeful.

Given the circumstances, I think it's as important what Congress does not do, as much as what it does do. We must reject steps to increase taxes or signal that we're increasing taxes, enact ill-informed protectionism, or take other actions that might undermine future economic growth.

I would yield back, Mr. Chairman.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 61.]

Chairman Schumer. Well, thank you, Congressman Brady. And now, Chairman Bernanke, you may take as much time as you wish.

Your entire statement will be read into the record.

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

Chairman Bernanke. Thank you. Chairman Schumer, Vice Chairman Maloney, Representative Brady, and other Members of the Committee, I am pleased to appear before the Joint Economic Committee.

In response to deterioration in the near-term outlook for the economy and intensified strains in financial markets in recent

months, the Federal Reserve has eased monetary policy substantially further and taken strong actions to increase market liquidity.

In my remarks today, I will first offer my views on conditions in financial markets and the outlook for the U.S. economy, and then discuss recent actions taken by the Federal Reserve.

Although our recent actions appear to have helped stabilize the situation somewhat, financial markets remain under considerable stress.

Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and have increased the amount of collateral they require to back short-term security financing agreements.

To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on securities prices.

Credit availability also has been restricted, because some large financial institutions, including some commercial and investment banks and Government-sponsored enterprises, have reported substantial losses and writedowns, reducing their available capital.

Several of these firms have been able to raise fresh capital to offset at least some of these losses, and others are in the process of doing so.

However, financial institutions' balance sheets have also expanded as banks and other institutions have taken onto their balance sheets various assets that can no longer be financed on a stand-alone basis. Thus, the capacity and willingness of some large institutions to extend new credit remains limited.

The effects of the financial strains on credit cost and availability, have become increasingly evident, with some portions of the system that had previously escaped the worst of the turmoil, such as the markets for municipal bonds and student loans having been affected.

Another market that has previously been largely exempt from disruptions was that for mortgage-backed securities issued by Government agencies. However, beginning in mid-February, worsening liquidity conditions and reports of losses at the GSEs, Fannie Mae, and Freddie Mac, caused the spread of agency MBS yields over the yields on comparable Treasury securities to rise sharply.

Together with the increased fees imposed by the GSEs, the rise in this spread resulted in higher interest rates on conforming mortgages.

More recently, agency MBS spreads and conforming mortgage rates have retraced part of this increase, and conforming mortgages continue to be readily available to households.

However, for the most part, the nonconforming segment of the mortgage market, continues to function poorly.

In corporate debt markets, yields and spreads on both investment-grade and speculative-grade corporate bonds rose through mid-March, before falling more recently.

The issuance of investment-grade bonds by both financial and non-financial corporations, has been quite robust so far this year, but issuance of new high-yield debt has stalled.

Strains continue to be evident in the commercial paper market as well, where risk spreads remain elevated and the quantity of commercial paper outstanding, particularly asset-backed paper, has decreased.

Commercial and industrial loans at banks, grew in January and February, but at a considerably slower pace than in previous months.

These developments in financial markets which themselves reflect, in part, greater concerns about housing and the economic outlook more generally, have weighed on real economic activity.

Notably, in the housing market, sales of both new and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall.

Starts of new single-family homes declined an additional 7 percent in February, bringing the cumulative decline since the early 2006 peak in single-family starts to more than 60 percent.

Residential construction is likely to contract somewhat further in coming quarters, as builders try to reduce their high inventories of unsold new homes.

Private payroll employment fell by 101,000 in February, after 2 months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline.

But the demand for labor has also moderated recently in other industries, such as business services and retail trade, and manufacturing employment has continued on its downward trend.

Meanwhile, claims for unemployment insurance have risen somewhat, on balance, and surveys indicate that employers have scaled back hiring plans, and that job seekers are finding greater difficulty in finding work.

The unemployment rate edged down in February and remains at a relatively low level; however, in light of the sluggishness of the economic activity and other indicators of a softer labor market, I expect it to move somewhat higher in coming months.

After rising at an annual rate of about 3 percent over the first three quarters of last year, real disposable income has since increased at only about a 1-percent annual rate, reflecting weaker employment conditions and higher prices for energy and food.

Concerns about employment and income prospects, together with declining home values and tighter credit conditions, have caused consumer spending to decelerate considerably from the solid pace seen during the first three quarters of last year.

I expect the tax rebates associated with the fiscal stimulus package recently passed by the Congress to provide some support to consumer spending in coming quarters.

In the business sector, the pullback in hiring that I noted earlier, has been accompanied by some reduction in capital spending plans, as weaker sales prospects, tighter credit, and heightened uncertainty have made business leaders more cautious.

On a more positive note, the non-financial business sector remains financially sound with liquid balance sheets and low leverage ratios, and most firms have been able to avoid unwanted build-ups in inventories.

In addition, many businesses are enjoying strong demand from abroad. Although the prospects for foreign economic growth have diminished somewhat in recent months, net exports should continue to provide considerable support to U.S. economic activity in coming quarters.

Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee at the end of January.

It now appears likely that real gross domestic product will not grow much, if at all, over the first half of 2008, and could even contract slightly.

We expect economic activity to strengthen in the second half of the year, in part, as the result of stimulative monetary and fiscal policies, and growth is expected to proceed at or a little above its sustainable pace in 2009, bolstered by a stabilization of housing activity, albeit at low levels, and gradually improving financial conditions.

However, in light of the recent turbulence in financial markets, the uncertainty attending this forecas, is quite high, and the risks remain to the downside.

Inflation has also been a source of concern. The price index for personal consumption expenditures rose 3.4 percent over the 12 months ending in February, up from 2.3 percent over the preceding 12-month period.

To a large extent, this pickup in inflation has been the result of sharp increases in the prices of crude oil, agricultural products, and other globally traded commodities.

Additionally, the decline in the foreign exchange value of the dollar has boosted some non-commodity import prices and thus contributed to inflation.

However the so-called core rate of inflation, that is, inflation excluding food and energy prices, has edged down recently after firming somewhat late last year.

We expect inflation to moderate in coming quarters. That expectation is based, in part, on futures markets' indications of a leveling out of prices for oil and other commodities and is consistent with our projection that global growth, and thus the demand for commodities, will slow somewhat during this period, and as I noted, we project an easing of pressures on resource utilization.

However, some indicators of inflation expectations have risen, and, overall, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully in the months ahead.

I turn now to the Federal Reserve's policy responses to these financial and economic developments.

Well-functioning financial markets are essential for the efficacy of monetary policy, and, indeed, for economic growth and stability. To improve market liquidity and market functioning and consistent with its role as the Nation's central bank, the Federal Reserve has supplemented its longstanding discount window by establishing three new facilities for lending to depository institutions and primary dealers.

The lending facilities now in place, offer depository institutions and primary dealers, two complementary alternatives for meeting

funding needs: One pair of facilities, the discount window for depository institutions and the primary dealer credit facility for primary dealers, offers daily access to variable amounts of funding at the initiative of the borrowing institution.

A second pair of facilities, the term auction facility for depository institutions and the term securities lending facility for primary dealers, makes available predetermine aggregate amounts of longer-term funding on preannounced dates, with the interest rate and the distribution of the awards across institutions being determined by competitive auction.

Although these facilities operate through depository institutions and primary dealers, they are designed to support the broad financial markets and the economy by facilitating the provision of liquidity by those institutions, to their customers and counterparties.

The primary dealer credit facility was put in place in the wake of the near failure of Bear Stearns, a large investment bank. On March 13, Bear Stearns advised the Federal Reserve and other Government agencies, via the Securities and Exchange Commission, that its liquidity position had significantly deteriorated and that it would have to file for Chapter 11 bankruptcy the next day unless alternative sources of funds became available.

This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be.

However the issues raised here, extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets.

With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence.

The company's failure could also have cast doubt on the financial positions of some of Bear Stearns's thousands of counterparties and perhaps of companies with similar businesses.

Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain.

Moreover, the adverse effects would not have been confined to the financial system, but would have been felt broadly in the real economy through its effects on asset values and credit availability.

To prevent a disorderly failure of Bear Stearns and the unpredictable, but likely severe consequences of such a failure for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through J.P. Morgan Chase.

Over the following weekend, J.P. Morgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The Federal Reserve has taken additional measures to improve market liquidity. We have initiated a series of 28-day single-tranche term repurchase transactions with primary dealers, expected to accumulate to $100 billion outstanding, in which dealers may offer any of the types of collateral that are eligible for conventional open market operations.

We have also expanded and extended reciprocal currency arrangements or swap lines with the European Central Bank and the Swiss National Bank. Using these swap lines, the participating central banks are providing dollar liquidity to financial institutions in their jurisdictions which should improve the functioning of the global market for dollar funding.

These facilities and programs will be kept in place as long as long as conditions warrant their ongoing use.

We are working closely with the Securities and Exchange Commission to monitor the financial conditions and funding positions of primary dealers who might seek Federal Reserve credit.

To date, the recent liquidity measures implemented by the Federal Reserve seem to have been helpful in addressing some of the strains in financial markets. Funding pressures on primary dealers appear to have eased somewhat, and liquidity seems to have improved in several markets, including, as noted earlier, the market for agency mortgage-based securities.

To the extent that these measures improve market functioning, they will have favorable effects on the ability and willingness to make credit available to the broader economy.

More liquid markets also increase the efficacy of monetary policy, which in turn, improves our ability to meet the goals set for us by the Congress, namely, to promote maximum employment and price stability.

As you know, in response to the further weakening of economic conditions, the Federal Reserve has continued to ease the stance of monetary policy. The FOMC reduced its target for the Federal Funds Rate by a total of 125 basis points in January, and by an additional 75 basis points at its March meeting, leaving the current target at 2.25 percent, 3 percentage points below its level last Summer.

As the Committee noted in its most recent post-meeting statement, we anticipate that these actions, together with the steps we have taken to foster market liquidity, will help to promote growth over time, and to mitigate the risks to economic activity.

Clearly, the U.S. economy is going through a very difficult period, but among the great strengths of our economy is its ability to adapt and to respond to diverse challenges.

Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are entrained, that should support a return to growth in the second half of this year and next year.

I remain confident in our economy's long-term prospects. Thank you, and I would be pleased to take your questions.

[The prepared statement of the Honorable Ben Bernanke appears in the Submissions for the Record on page 62.]

Chairman Schumer. Well, thank you, Mr. Chairman. Just to notify my colleagues, because we didn't have time for opening statements, and everyone has so much to ask, we're going to do 7-minute rounds for everybody.

Mr. Chairman, on page 4 of your testimony, you say that the economy could, quote, "even contract slightly." I think this is the most pessimistic you have been about the possibility of recession.

Am I correct in understanding that you now believe a recession is possible, certainly more likely than it was a few months ago?

Chairman Bernanke. A recession is possible, but a "recession" is a technical term, defined by the Bureau of Economic Research, depending on data which will be available quite awhile from now, so I'm not ready to say whether or not the U.S. economy will face such a situation.

However, it's clearly a period of very slow growth, extending back to the fourth quarter of last year, and we are trying to set our policies appropriately for that situation.

Chairman Schumer. Do you believe the economy is contracting right now?

Chairman Bernanke. Our estimates are that we're slightly growing at the moment, but we think that there's a chance that for the first half, as a whole, there might be a slight contraction.

Chairman Schumer. Thank you, Mr. Chairman. Next, I just want to go to some of the Bear Stearns questions. I mentioned that there were "before" and "after" questions, and I'm going to ask you a few of those, and then you can speak at some length.

The first question everyone wants to know, I think, is, at what time did the Fed—the members of the Fed and you, become concerned about the long-term viability of Bear? What happened after the two hedge funds became in trouble? Did you have any idea that Bear might go bankrupt before they notified the Fed, and could earlier, more aggressive action by one of the Government regulators—private action, most probably—saved Bear? And, going forward, there are two issues:

One, in order to avoid a future situation, what actions has the Fed taken subsequently to deal with a possible similar situation, that is, a freeze up of liquidity? I know you've gone to the discount window and you don't have to elaborate on that.

Are there any other actions taken, particularly in regard to individual firms? I don't want you to mention which ones just in general.

And do you expect the Bear Stearns situation to—in light of Bear Stearns, do you expect the Fed and the SEC to be more proactive in protecting investors from a future Bear-like situation?

Then, finally—and you can again answer these at some length—how is this different from housing? In other words, housing—one of the things that bothers many of us, is not the necessity of Government intervention at Bear, but what about Government intervention in the housing market?

Admittedly, each homeowner does not pose systemic risks, but as a group they do, and how can one justify going in with Government backup for Bear or any large financial institution, but not for the millions of homeowners? So you have the time to answer.

Chairman Bernanke. Senator, I'll try to be responsive to those questions.

We do not, of course, have direct supervisory authority for Bear Stearns. We have monitored the company for some time through direct contacts at the SEC.

And there obviously have been periods where the market was concerned about Bear Stearns. Its share price have fallen, its credit default swap spreads have risen, and so on.

We did not have early warning on the most recent episode. The SEC viewed Bear Stearns as having adequate capital, relatively a short period before the events.

Chairman Schumer. In retrospect, do you agree with that? Did they have adequate capital?

Chairman Bernanke. They may have had adequate regulatory capital, but their problem was more liquidity than capital.

What happened, was that there were certainly market concerns about their positions, and confidence began to erode and they began to lose their funding.

We were not informed of the imperative of the situation until about 24 hours before the event, probably on Thursday, that likely they were going to be in default on Friday morning.

It was at that time that we began our emergency response. Normally, we would have more warning and we would have more time to develop a more effective response.

Going forward, we continue to monitor financial institutions, we hope to improve the liquidity situation by extending liquidity to investment banks and dealers, as well as to depository institutions.

As supervisors, we continue to insist on strong capital and push banks to raise capital. We also have a particularly strong interest in liquidity, as we have had over the last few months.

I certainly hope and do not expect a repeat of this episode, but the future is uncertain, and we will obviously have to just keep monitoring what's happening.

With respect to housing, I'm very glad you asked that question.

Chairman Schumer. Are you working closely with the SEC to monitor individual firms more carefully? I don't think the relationship between capital and liquidity is as removed as you're implying.

Other companies had similar exposure to Bear, but because they had more capital—Bear, I think, cut the capital as low as they could—more capital might help deal with the liquidity crisis, so I guess I'm just asking, are you in concert with the SEC, keeping an eye on individual firms and making sure they have a large capital cushion, given what has happened?

Chairman Bernanke. Yes, Senator, both capital and liquidity are important, and we are urging firms to raise more capital. The fact that we saw yesterday, a large bank and an investment bank raise capital, is suggestive that capital is available in the marketplace.

Since we've begun lending to dealers, including the remaining investment banks, we have been—we've put examiners on the ground in those firms, and we've established offsite teams that coordinate with them so we want to be sure that any lending we do to the investment banks will be done on an appropriately sound basis.

So we are now currently onsite in the investment banks, working with the SEC. We're getting excellent cooperation both from the SEC and from the firms to make sure that we're comfortable with the financial positions of those firms.

On housing, I'm very glad you asked this, because I think there's sort of a false dichotomy here. We did not bail out Bear Stearns. Bear Stearns shareholders took a very significant loss.

An 85-year old company lost its independence and became acquired by another firm. Many Bear Stearns employees, as you know, are concerned about their jobs.

I don't think any company is interested in repeating the experience of Bear Stearns.

We did what we did because we felt it was necessary to preserve the integrity and viability of the American financial system, which in turn, is critical for the health of the economy. Anybody who wants to borrow for a mortgage for a house or for other purposes, anyone who has an investment account with stocks and other assets in it, anyone whose company wants to acquire capital to expand employment needs to have a healthy, functioning financial system.

What we did—always in my mind, what was the best thing for the American public? And that's why we took that action, and I believe that was the benefit of that action, not to help individual Wall Street people.

I would just like to say one thing, which is, the Federal Reserve has done a great deal to try to help on the housing front. Our interest rate cuts and our liquidity measures, in particular, have significantly reduced the interest rate reset problem faced by many mortgage holders, and we have extensive efforts on the ground at our Reserve Banks and our branches, to work with community groups, including NeighborWorks, for example, to help reduce delinquencies and the problems of foreclosure.

So I do believe, to complete my thought—Representative Maloney raised the question, and I do think Congress needs to be looking at housing. I think it is the center of the situation, the center of the problem at this point.

I do think that strengthening the FHA, strengthening GSEs to do their mission, those are all constructive things, and I hope Congress will address housing issues, going forward.

Chairman Schumer. But don't you feel there is a dichotomy between Federal intervention, if losing taxpayer money to prevent systemic failure is appropriate to do for a large investment bank, isn't it just as appropriate to do it in the housing market because that also, as a whole, presents systemic risk issues?

That's the dichotomy many of us are troubled about. I'm not saying one is a bailout and one is not a bailout, or anything like that.

Chairman Bernanke. Well, the Federal Reserve was acting in its sphere of influence, to address financial issues. As I've said, I think housing is very important and we need to address it, but of course, that's the Congress' sphere of influence, not the Feds.

Chairman Schumer. Thank you. I'm just going to go in the order here of when people came in, so people know. It's Senator Brownback, Vice Chair Maloney, Representative Brady, Senator Bingaman, Senator Sununu, Senator Casey, Representative Paul, Senator Klobuchar, Senator Bennett, Representative Doggett, Representative Sanchez, Representative Cummings, and I have, with the permission of both—and Senator Webb just came in—I have permission—I've asked permission, and I hope the Committee will give it to us, Senator Kennedy—I asked Senator Brownback and Congresswoman Maloney—he's involved in something else and wanted to come in and ask questions. He was here earlier—to pre-

serve his place, and I'm going to recognize that authority, if nobody objects.

Senator Brownback.

Senator Brownback. Thank you, Mr. Chairman.

Mr. Chairman, you've stepped in on Bear Stearns, and you used authority, as I understand, that hasn't been used since the Great Depression.

Obviously, the Fed looked at Bear Stearns and said, this place is too big to fail, because they could have gone through the bankruptcy proceeding, and that's what they had indicated to you that they were going to do.

What governs the Fed's decision on whether to take on the risk of these assets? You say we didn't bail them out, but we put in—we've got $29 billion of U.S. taxpayer-backed assets now that in the private sector are being backed by the U.S. taxpayer.

What governs the Fed's decisions on whether to go into this? Then I'm going to follow up with that and ask you, do we have other candidates that we may be doing this with in the near term?

Chairman Bernanke. Well, our decision was based on two criteria: The first was Bear Stearns itself and its interconnectedness and importance in the financial system—the thousands of counterparties that it has, the important markets in which it participates, and the shock that we thought that its unexpected failure would have on the financial system.

The other criterion was the fact that the markets are very fragile, and perhaps in a more robust environment we would have made a different choice, but in the current environment, we felt that it was too risky to allow this to happen if we could avoid it.

Now, it was not clear that we—we have no authority to buy the firm or anything like that. What we tried to do was arrange, as often happens in the case of banks that are in trouble—for example, the FDIC will try to arrange a merger or an acquisition with another bank—so essentially, that's what we tried to do to get J.P. Morgan Chase or any other firm that was interested, to come and acquire Bear Stearns.

The $30-billion assets—we lent $29 billion against $30 billion of assets, and that was an extraordinary thing to do. I thought about it long and hard. I would hope not to ever do it again.

I think the risk is much, much less than $30 billion, because we do have assets behind that loan.

But we did it essentially because it was needed to facilitate the transaction, and we were persuaded that without that assistance, that the transaction would not go through and that the consequences would be severe.

Again, that's not something we hope to do in the future, and it was quite unusual, as you point out.

Senator Brownback. So you're noting that this is the situation, and it's a bit of situation ethics, I guess, is what you're saying, that you wouldn't have done this 10 years ago, you may not do it next year, but in this situation.

Do you have other private companies that you're—if they are in a similar situation to Bear Stearns, then you're basically saying that in this environment, we would likely to do this?

Chairman Bernanke. You know, I really can't answer that question in advance. It's going to depend on the situation and depend on the markets.

We do not currently have concerns of this type, but obviously, we're monitoring the entire market and all the major companies. Again, I hope this is a rare event; I hope it's not something we ever have to do again, but, clearly, we do have to watch the markets and do what we can to ensure financial stability.

Senator Brownback. What's the biggest factor you're watching right now on this economy that you're most concerned about?

Chairman Bernanke. Well, I think, as I mentioned earlier, that housing is very much at the center of both the economic situation and the financial situation.

While credit issues and financing issues have spread throughout the financial markets, the worst problems are still in the mortgage area. The largest proportion of the writedowns that have been taken by banks and other financial institutions have been related to mortgage assets.

So, as we look forward, the issue of, you know, when the housing market will stabilize and how much house prices will adjust and so on, is very important as we think about both financial and economic developments.

Senator Brownback. You mentioned that Congress should act in the housing field. One of the things being considered is a change in the bankruptcy law, allowing a restructuring to take place on the housing loans. That's being proposed.

Do you have a view—you didn't mention that in your items that you support. You mentioned a series of items you support, and you didn't mention that.

Do you have an opinion of that, the impact of that legislation on the housing market?

Chairman Bernanke. Well, there are arguments on both sides in that case. In favor is the idea that perhaps Bankruptcy Courts could achieve a more efficient and quicker resolution. On the other side, are concerns about delays that might occur in the Bankruptcy Courts and the possibility that what would be perceived as a breach of property rights would lead to higher interest rates in the future.

So I think it's a tough question. The Federal Reserve did not take a position on the last Bankruptcy bill, and I think we're going to stay neutral on this one, as well.

Senator Brownback. I might point to you that I've been traveling around my State and a number of companies are hiring people in manufacturing, especially with an export orientation. They're hiring aggressively. I know that the dollar's impact has been positive overall for us in that situation.

I do want your quick opinion, if I could get it, on this massive overhaul of the regulatory structure that's being proposed by the Treasury Department. Is this something that you believe is necessary, given the changed financial markets, or would you care to comment?

Chairman Bernanke. Well, as Senator Schumer mentioned, the financial markets have changed a lot since the 1920s and the

1930s, and we need to think about how our regulatory system lines up with the existing structure of financial markets.

The Treasury plan, I think, is a very interesting and useful first step. It points out essentially the three essential functions of regulatory agencies: The prudential, the market stability, and the business conduct functions.

I think we all agree that there's going to be quite a bit of discussion and analysis before we are ready to do major changes in our regulatory structure, but I do think that it's well time for us to be giving that serious consideration.

Senator Brownback. Are there particular provisions of it that you do agree with? You've said that on the overall package, it's an interesting starting point, I guess you had put it, to the discussion. Are there particular pieces of it that you clearly agree with and believe are needed?

Chairman Bernanke. Well, I would just make one comment, which is that one of the ideas in the blueprint, is to give the Federal Reserve sort of broad authority to be a financial market stability regulator.

The Federal Reserve has a long tradition of trying to maintain financial stability, and is very interested and concerned with those issues, but we would want to be sure that if we were given that very important responsibility, that we had adequate powers, authorities, expertise, and so on, to make sure that we could do it effectively. So that would be an issue for us to think about as we go forward.

Senator Brownback. Thank you, Mr. Chairman.

Chairman Schumer. Vice Chair Maloney.

Vice Chair Maloney. Thank you.

Mr. Chairman, I take it you would agree with me that the first principle in a financial crisis like this one must be "do no harm." Recognizing this, what types of new legislation or regulation most concern you in that they could in the near-term reduce liquidity, increase the financial stress on banks and major financial institutions, or otherwise constrict rather than loosen the money supply?

And specifically, what is your view on the role of Congress at this point in the financial crisis? Do you believe that the Frank-Dodd proposal to inject $300 billion into the housing market through a guaranteed loan program at the Federal Housing Authority is the right policy choice at this time?

Chairman Bernanke. With respect to housing, as I have indicated, I am in favor of strengthening and expanding the FHA, giving it more powers and authorities, adding counseling provisions, and the like.

I am still focused on a loan-by-loan approach where on a voluntary basis servicers could choose to modify loans in a way that would make them eligible for FHA refinance. I think that is where I am comfortable right now.

Vice Chair Maloney. But the statistics that we have been seeing show that it has not been working; that the people have not been coming forward, or they have not been working these loans through.

If we are going to be there to be a Federal backstop to the financial institutions, should not we also be there as a financial backstop

to people that are losing their homes? And we are talking about a loan guarantee. Hopefully all of this money would be paid back.

But let me ask, what would be the most effective measures that Congress could take that would work in tandem with the Federal Reserve's actions?

Chairman Bernanke. Well eventually in the longer term, as we indicated and as has already been mentioned, we would want to think about the regulatory structure. We are already taking steps, for example, on our own side on regulation for making new mortgage loans, and so on.

In the near term, as I indicated, I think the best thing that Congress can focus on is the housing situation. I agree with that. I think there are problems both with the existing loans that are going bad, and where there are potential foreclosures are there ways to prevent unnecessary foreclosures. That is a very important issue.

But I think also going forward for the housing market to recover it would be helpful for example for the mortgage markets to be working more effectively and more efficiently. GSE reform and GSE capital raising would be one way to try and strengthen the mortgage markets for people going forward who want to buy homes.

So I think that is the area right now for the economy and for the financial markets where I would recommend Congress put its attention.

Vice Chair Maloney. Going back to the topic of regulation that has been raised by my two colleagues, the Federal Reserve has long opposed tighter regulation and oversight over hedge funds, arguing that such funds provide enormous liquidity to the United States and global financial system.

Given recent news reports about hedge funds having made huge bets against the stock price of Bear Stearns during the week leading up to its collapse, and now reports that Iceland is investigating whether certain hedge funds may have played a role in beating down its currency, do you believe there is a need for any new regulatory oversight of hedge funds? And if so, what type of oversight?

Chairman Bernanke. Congresswoman, the concerns that you raise, and similar ones, are examples—if they were true of course—of market manipulation, which is already the province of the Securities and Exchange Commission and which I am sure will look into these contentions.

So I certainly do not have any objection, or any problem with enforcement of the securities laws and of investor protection in the context of hedge funds.

It has been remarkable. The hedge funds have been less of a problem than we anticipated in some sense, and we have seen more problems in some other sectors. So far one of our main concerns had been that hedge funds that failed would create losses for their counterparties, the major financial institutions. Thus far we have not seen any significant losses taken by a major financial institution because of a hedge fund loss or failure.

So in that respect their behavior has not so far created risks for our major financial institutions.

Vice Chair Maloney. Yet some reports were that hedge fund losses at Bear Stearns led to their challenges.

Chairman Bernanke. Well ironically those were Bear—those were hedge funds sponsored by Bear Stearns itself and therefore in principle under the oversight of Bear Stearns' regulator.

Vice Chair Maloney. I wonder, Mr. Chairman, if you could spend some time discussing the two new lending facilities recently established by the Fed, the Term Securities Lending Facility and the Primary Dealer Credit Facility?

These seem to be targeted at enhancing liquidity in the credit markets, particularly to mortgage markets. And my understanding is that the Fed will effectively lend to banks and to investment banks who are primary dealers using certain securities as collateral.

And, importantly, the collateral eligible for pledge under these facilities include residential and commercial backed securities. Isn't the idea that the process of pricing these securities for these facilities should help markets establish a mark and improve the ability of primary dealers and banks to provide liquidity to participants?

And, Mr. Chairman, what has been the impact of these new programs to date?

Chairman Bernanke. Congresswoman, our goal in those new programs is to provide liquidity, not to provide credit enhancement or effect prices. So those two new programs are essentially analogous to what we already do for banks.

The Primary Dealer Credit Facility is like a discount window that we have for banks. It allows the primary dealers to come and to borrow short-term. And some of them have been using that facility.

The Term Securities Lending Facility is similar to the Term Auction Facility we have for banks. It allows for an auction which auctions off funds for a 28-day period.

In both cases, in all four cases, the loans that we make are fully collateralized. There are haircuts taken. We have rights to exchange collateral which has gone bad. We have not only rights to the collateral but also rights' recourse to the borrower itself.

To my knowledge, the hundreds of billions of dollars we have lent to these facilities and other facilities in past years we've never lost a penny. So this is a liquidity process. This is not a subsidy. It is not a credit allocation process.

Vice Chair Maloney. My time has expired. Thank you.

Chairman Schumer. Thank you, Vice Chair Maloney.

Congressman Brady.

Representative Brady. Thank you, Mr. Chairman.

Let me ask a laymen's question, Mr. Chairman, if I may. The Fed has taken aggressive actions to stabilize the financial markets. There are multiple reductions in short-term interest rates and an expectation it will occur again at the end of the month. The cuts in the Federal Fund Rates. The Bear Stearns containment, and the new lending facilities for primary dealers.

I know it is too early to tell, but if those actions do not calm the liquidity waters or prevent additional spillover into the rest of the economy, what bullets does the Federal Reserve have left in its guns, traditional or otherwise?

Chairman Bernanke. Well we have been pretty creative up till now. I think we probably can find some additional tools. And of course we still have monetary policy to use to try to strengthen and stabilize the economy. I will not hesitate, should I think that we need assistance from the Congress, to come and speak with you and to speak to the Administration to try to discuss possible options.

But for now I think we have a full complement of liquidity provision tools. We have reduced the Federal Funds Rate by 300 basis points. We believe we are making an important contribution to trying to resolve both the financial issues, but also the slowdown in the economy.

Representative Brady. Do you anticipate more nontraditional tools, weapons in this effort? Or do you think traditional ones, depending on how it moves, will work?

Chairman Bernanke. We do not have anything currently planned that is about to be unleased. We think we have a number of things already that we are using, and we hope that they will prove effective.

Representative Brady. While our economy is—shifting gears just a bit—it is also very resilient, and has proved such, I often worry about Congress really getting in the way of recoveries and corrections occurring.

Right now, given the current economic conditions, job uncertainty, consumer confidence at a loss, loss of net household worth, would this be an especially bad time for Congress to consider significant new tax increases?

Chairman Bernanke. Well in the short term certainly I think new tax increases would reduce disposable income and consumption, and I think that would be a concern.

Obviously in the longer term, tax policy needs to be based on long-term questions of efficiency and revenue requirements that Congress—only Congress can decide.

Representative Brady. But at this point an increase provides more of a risk than a means for recovery?

Chairman Bernanke. The Congress has just, of course, passed a stimulus package which has the effect of increasing disposable income and reducing taxes, or creating tax rebates.

Representative Brady. On Secretary Paulson's proposal for the Fed to become a market stability regulator, what are your views on that proposal?

Chairman Bernanke. As I indicated earlier, the Fed has always had a strong interest in market stability and financial stability. We were created in 1913 in response to the 1907 financial panic, and the Fed, for the most part with the very glaring exception of the 1930s, has been an effective financial stability regulator since then.

The world has changed a lot in terms of its structure, and I think it is worth considering whether there are additional steps that need to be taken in order to ensure stability in our brave new world, our much broader, more diverse set of financial institutions.

As I indicated before, though, my main concern would be that if we are to be given this broad power and this broad responsibility

that we have the adequate tools necessary to discharge that responsibility effectively.

Representative Brady. All right.

Thank you, Mr. Chairman. Let me yield back.

Chairman Schumer. Thank you, Congressman Brady. And now Senator Bingaman is not here, so Senator Casey.

Senator Casey. Mr. Chairman, thank you very much.

Chairman Bernanke, we are happy to have you here again. We appreciate your testimony. I wanted to ask you a couple of questions with regard to the Bear Stearns deal that center on valuation of collateral.

Anyone who is watching this hearing knows that any of us who borrow money or enter into some kind of loan transaction must have collateral. I wanted to talk to you and ask you a couple of questions about how you arrived at this determination with regard to the valuation of collateral.

First of all, I want to make sure the record is clear on this. In terms of the valuation of the collateral, is it based exclusively or principally upon any Bear Stearns models?

Chairman Bernanke. The valuation, the primary valuation was done by Bear Stearns on March 14, so currently, using best-available market information, and including adjustments for the fact that those markets are quite illiquid, which is important.

We have had our investment advisor, BlackRock, go through those assets and they are confident—or at least reasonably confident—that we will be able to recover the full amount if we dispose of these assets on a measured basis, rather than to sell them all at once.

Senator Casey. But has either the Fed or the investment advisor done their own independent valuation?

Chairman Bernanke. Yes, the investment advisor has been working on that collateral throughout.

Senator Casey. In other words there is a separate, independent evaluation?

Chairman Bernanke. I believe so. Let me make just a general comment, which is that obviously there is a lot at stake in these issues. There is a lot of litigation outstanding. The deal is not yet done.

Tomorrow in front of Senator Dodd's committee all the requisite agencies, including the Treasury, the SEC, and the Federal Reserve Bank of New York will be together to testify and we will be able to make sure we have exact information at that time.

I want to be just very careful about not making statements that would turn out to be even partially incorrect. But to my knowledge, to the best of my knowledge, the collateral has been independently evaluated by the BlackRock Investment Advisory firm.

Senator Casey. If it turns out at some future time that the valuation, the independent valuation, comes in at less than $30 billion—in other words, if there is a shortfall or a gap—can you then go back to Bear Stearns or JPMorgan to obtain more collateral?

Chairman Bernanke. No, we cannot.

Senator Casey. Now in terms of your investment advisor, can you tell us something about how they were chosen, number one? And what they will be paid?

Chairman Bernanke. Again, this is the details. I will speak only from my indirect knowledge because this happened in New York.

We were operating obviously under extreme time constraints. This negotiation was going on over the weekend with the need to have it completed by the time that the Asian markets opened on Sunday.

The Federal Reserve Bank of New York engaged BlackRock on a fee-to-be-determined-later basis. That is to be negotiated later. And brought them in to look at the assets.

They are a highly respected firm. I think that, you know, opportunity to do, you know, a full requisition for services and, you know that competition for bids and those sorts of things was simply not practicable given the short time period.

Senator Casey. Just generically, how would they be paid? Is it a straight fee? Or is there any other arrangement just generally in a situation like that in terms of what the Fed would do?

Chairman Bernanke. I just don't know the answer for sure, and therefore I would prefer to leave it to President Geithner who could answer that question for you.

Senator Casey. Going back to the collateral, the assets, in terms of the quality, what did the Fed do in this instance to make a determination or an evaluation of the quality of the assets that are a part of this arrangement?

Chairman Bernanke. Well again, we had BlackRock look at them. I can also say that the assets are entirely investment grade. They are entirely current and performing. They have been valued currently based on current market information. So we, you know, I think that we did what we could to assure ourselves that the collateral was, was what it was—was worth what it was supposed to be worth.

Senator Casey. Do you have any sense—and I know this may be hard to recall in terms of days—but any sense of the time period between your retaining the investment advisor and their opinion with regard to the value of the collateral being—in other words, that determination was made?

In other words, how much time did they have?

Chairman Bernanke. I don't know the exact answer. I would have to leave that to President Geithner.

Senator Casey. We're talking about days, as opposed to——

Chairman Bernanke. Probably, but I don't know.

Senator Casey. And finally, I want to move on to another topic. In prior appearances before our Committee, and I am sure others as well, you have talked about, and I have asked about, and others have, about the gap between wages and productivity.

We have this unfortunate dichotomy between rising productivity over time, the American worker producing more and wages either going down in some sectors or being flat. What is your sense of that in terms of where we are now? And what do you see coming up down the road between the juxtaposition of rising productivity and flattening or low-growth wages.

Chairman Bernanke. Well historically the labor share, which is essentially the wage/productivity relationship, has tended to revert to a stable level.

It has been away from that level for some time now. Part of it may have to do with other costs, like medical costs and other sorts of benefits, but I think it is also true that there is greater wage inequality at this time. There's more wage gains or compensation gains for the highest skilled or the most, the best compensated workers.

I have talked in speeches about inequality issues. I think they are important. I think we need to address them through a variety of measures. The most important one in the longer term certainly is education and skills' acquisition.

But it remains a concern. Real wages certain in the last year have been essentially flat in part because of the rapid rises of food and oil prices, which of course effect people's budgets. But in a growing economy certainly we hope to see real wages rising and real income rising as well.

Senator Casey. Thank you.

Chairman Schumer. Thank you.

Senator Sununu.

Senator Sununu. Thank you, Chairman Schumer.

I want to get back to the issue of home ownership. A number of the panelists have suggested that, while the Fed has taken action with regard to Bear Stearns, that the Government has done very little to address and support the issue of home ownership.

I think it is important that we understand what actions have been taken in that area, what programs we have in those areas, and what we might do.

Then I want to get back to your point about how the Fed actions may or may not have affected and supported home ownership already.

Within the Government we have a number of programs that address home ownership, a number of new programs under the Housing Administration, the FHA, to directly support people who hold subprime mortgages, to refinance them and to help people who are behind on their payments.

We have a housing tax credit program, a very important program that supports low- and moderate-income housing. We have the HOME program that provides over a billion dollars in grants each year to support home buyers, especially first-time home buyers.

We have a very significant program through the Tax Code of mortgage interest subsidies. And then of course we have Fannie Mae and Freddie Mac, large Government-sponsored enterprises that enjoy significant subsidies, including exemption from local taxes, a Treasury line of credit, and the much-discussed implied Government guarantee.

And they have in turn helped to finance home mortgages around the country—a very large number of home mortgages, both for first-time buyers and for new buyers.

The issue of improving and strengthening the regulator of the GSEs has been much discussed. You have mentioned it before this Committee many times before. I authorized legislation with Chuck Hagel to reform and modernize the regulator of the GSEs, and I think it is important to note that that is legislation that we have talked about well in advance of this crisis. And it is legislation that has been delayed by efforts on the part of Fannie Mae and Freddie

Mac, and the Democratic leadership in Congress to weaken the powers of that regulator.

I think that is very disappointing, and I would hope that that is something that we can get done now that we have a crisis. We should enact this legislation before we have a crisis, but now that we have, I hope that that is something we can do.

There are other things we can do to advance the issue of home ownership and address the current crisis, things that are supported on a bipartisan basis: expand the bonding authority of the Housing Finance Administration to take better action in the subprime crisis.

We have an FHA modernization bill. I know you have already mentioned that. That would give greater flexibility to FHA. That has strong bipartisan support. And there is a discussion of bipartisan support for providing tax credits to people buying distressed housing.

So I think it is important for all of us to understand that we have significant programs. We have expanded some of those programs, and we need to look at additional steps that can be taken to address home ownership.

But the suggestion that the Feds taking action but nothing else has been done I think is a little bit misleading.

And in answer to Senator Schumer's question about this point, you replied that you felt that the actions taken by the Fed in the case of Bear Stearns did have an impact on home ownership.

I think Senator Schumer seemed not to quite understand the answer because he came back to the point that he wasn't opposing action in the case of Bear Stearns, but he also wanted to see action in the case of home ownership.

So I want to come back to this very same question. I want you to be specific. The Fed took action related to the potential collapse of Bear Stearns. How do you think that action affects home ownership, those looking to buy a home, those who have mortgages, those who are seeking to refinance, how were they affected by the Fed's action with regard to Bear Stearns?

Chairman Bernanke. Well quite directly. Our actions with respect to Bear Stearns and also our liquidity provision and all those measures have relieved to some extent the funding pressures and liquidity pressures in the markets.

The spread between conforming mortgage rates and GSE debt costs and Treasuries had expanded considerably for a variety of reasons, including liquidity problems. Our actions, I believe, contributed to the recent decline in those liquidity premia have brought down 30-year conforming mortgage rates, you know, a significant amount. So I believe there has been a direct impact.

I think also that it may be a bit indirect but I believe that a serious crisis in the financial markets could not have helped the confidence of savers and investors to go and make investments in new housing, for example.

Senator Sununu. The issue of spreads regarding conforming rates may not be the kind of direct language that we've all been praying for from Fed Chairmen for a long time. Does that mean that rates are lower for people looking to buy a home today?

Chairman Bernanke. Our policies, our interest rate policies and our liquidity policies and our actions with regard to Bear

Stearns I am confident imply that today's mortgage rates are considerably lower than they otherwise would be.

Senator Sununu. For those looking to buy, or for those looking to refinance, as well?

Chairman Bernanke. For those looking to buy and for those looking to refinance, that's correct.

Senator Sununu. There was some discussion made in opening statements about reference made to the Depression. No one wants to see economic times even remotely similar to what the country had to bear during the years of the Depression.

You may not be prepared to answer questions about the Depression. I'm not sure about your background in this area. Maybe it is pretty substantial. Could you speak a little bit about the differences between the challenges the country was facing during the Depression and today?

And in particular, what actions with negative consequences were taken then that you are confident we will avoid in today's situation? And what positive actions were not taken during the Depression that you feel we either already have or have the ability to take in the current situation?

Chairman Bernanke. Well one of the prevailing theories at the time of the Depression was the so-called liquidation thesis which said basically let's just let the system return to normal. Let's liquidate the banks. Let's liquidate labor. This was Andrew Mellon the Treasury Secretary. It was partly on the basis of that theory that the Federal Reserve stood by and let a third of the banks in the country fail, which created the money supply to drop sharply and cause prices to fall very sharply and led ultimately to the severity of the financial crisis.

I think financial instability, which was not addressed by Government or anyone else, was a major contributor both to the Depression in the United States and abroad. I believe the difference today is that, you know, that we will address financial issues and try to maintain the integrity and stability of our financial system.

We will not let prices fall at 10 percent a year. You know, we will act as needed to keep the economy growing and stable. So I think there are very significant differences between the 1930s and today, and we learned a great deal from that episode.

Senator Sununu. Thank you, Mr. Chairman.

Chairman Schumer. Thank you.

Senator Klobuchar.

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

Chairman Bernanke, following Bear Stearns' demise, the papers were filled with postmortems, all of them having different theories on why it happened.

What is your theory on how one of the top five investment banks in the country, and why this particular bank failed in such a dramatic fashion?

Chairman Bernanke. First let me again repeat that there will be a hearing tomorrow with all my colleagues from the Treasury, the Federal Reserve Bank of New York, and the SEC, all of whom have particular expertise on this issue. And I hope we will get fuller and more detailed answers on all these issues going forward.

My own sense of Bear Stearns was that they did have various issues with some of their investments, and that there were concerns about that in the public. And there were various concerns about some of the holdings they might have at that time, at the time of the week of their potential failure.

What happened though was basically a loss of confidence in Bear Stearns and their funding fell away, which emphasizes the importance of maintaining adequate liquidity and shows why our liquidity provision can be of assistance to firms that are otherwise potentially sound.

Senator Klobuchar. And then you also think it leads to the conclusion that we should have more oversight responsibility?

Chairman Bernanke. I think that we do need to have good oversight of all systemically important firms to make sure that they have adequate capital and adequate liquidity.

Senator Klobuchar. Now in answer to Senator Brownback's questions he was asking you about Secretary Paulson's idea about having the Federal Reserve take on more responsibilities, you commented that if you were to do that you would need more resources and more expertise.

Could you expand on that? What type of expertise would you need? How many resources would you need?

Chairman Bernanke. Well the concern I would have is the following:

As I have talked about in various speeches and other contexts, the Federal Reserve's current authorities to examine banks and to make rules for banks, including capital rules for example, provides us with an enormous amount of information, as well as the expertise that we need to understand what is happening in the financial markets.

So I would be very worried if we were expected to manage the stability of the financial system, but lost all of our authority to enter banks to assure ourselves that they were safe and sound and, if necessary, to make additional rules to preserve their financial stability.

So I think we would continue to require the ability to evaluate, and in some cases, make rules concerning the financial systemic stability of major financial institutions.

We could not successfully carry out this mission if we had to rely entirely on second-hand reports from primary supervisors of these individual institutions.

Senator Klobuchar. So you would need more information, and you wouldn't see this as a conflict with what you are doing now? You would just need a different kind of statutory role?

Chairman Bernanke. What we are doing now achieves much of what I am talking about. We have of course regulatory authority, and supervisory authority for bank holding companies which gives us a window into what is happening in the banks and major institutions.

We would need something equivalent to that, something that involves our ability to not just receive reports periodically from these prudential supervisors, but the opportunity to actually go into the bank or the other——

Senator Klobuchar. So more investigative responsibility?

Chairman Bernanke. Well things that are similar to what we have now. I am really arguing that we should not lose some of the powers we have now, which involve our ability to go into banks, make our direct assessments of their safety and soundness and, if necessary, make rules that would keep them safe and sound from a systemic point of view.

Senator Klobuchar. Congressman Brady was asking you about taxes and about tax policy, and you were talking about how that is in the responsibility of Congress. But are you concerned at all—I was thinking about back when President Clinton was in and Secretary Ruben, and how they were able to get the confidence of Wall Street, really, based on some changes to our fiscal policy.

And we have been frustrated, some of us, in the last year as we try to pay for things, whether it's the AMT fix by taxing some of the hedge fund operators, or some of us who believe we need to roll back some of the tax cuts for the wealthiest to be able to actually be more fiscally responsible.

Do you believe that this situation with our increasing debt and the lack of action by some in Washington has contributed at all to this financial crisis and the lack of confidence in our country?

Chairman Bernanke. Well, I think that the deficits and those issues are perhaps not the primary causes of the current situation, but they certainly have very important long-term consequences, and I do think they are very important to address.

I have said a couple of times that I do not advocate laws here, but I do advocate the law of arithmetic. The law of arithmetic says that if you want to be in favor of low taxes, then you also need to have the associated spending cuts that make that feasible.

If you want to be a high-spending person because you think Government programs are valuable, then you also have to accept the tax implications.

So my main message I think is that there does need to be a reconciliation of spending and taxation plans over long periods of time.

Senator Klobuchar. Do you—I think it's $1 out of $12 of our Federal tax dollars that people pay out go to interest on this debt—think that it could be contributing in some way to our volatile situation in our economy?

Chairman Bernanke. Again, I don't think that the current situation is primarily related to those issues. But in the longer term I do think it would have potentially destabilizing financial effects, and I do think it is important for the Federal Government to get control of its long-term budget position.

The Congressional Budget Office has provided us with plenty of scary scenarios where the debt to GDP ratio goes over 100 percent, and debt becomes essentially, you know, the debt and entitlement spending becomes the entire Government budget.

Clearly we cannot get to that position, and I hope that we will find solutions before it gets so imminent that it becomes very, very difficult.

Senator Klobuchar. One last thing on the economy. You talked about the Futures Market, and oil prices potentially settling down, but one of the things we are exploring right now, Congressman Markey had a hearing yesterday with the oil executives, and one

of the things we are looking at is all of these tax incentives when they are having record profits, and how those could probably be put into renewables and things that will help our own country.

Do you think it is true that tax incentives to oil companies provide little or no significant relief to Americans when the world market seems to respond more to what OPEC is doing than what we are doing here in Washington?

Chairman Bernanke. I think that is outside of my sphere of responsibility.

Senator Klobuchar. Well you brought up oil prices.

Chairman Bernanke. I didn't bring up oil tax policy.

[Laughter.]

Senator Klobuchar. All right, we will go on for another hearing, then. Thank you.

Vice Chair Maloney [presiding]. Congressman Paul.

Representative Paul. Thank you, Madam Chair.

Welcome, Chairman Bernanke. There is a political philosophy that advocates the merging together of the interests of business and Government, at the same time with a loss of civil liberties of the people.

I am afraid we are moving in that direction, not just in the last year or two but over many, many years. When you think about it, especially since 9/11 there has been some loss of civil liberties that we should not be unconcerned about. There are warrantless searches, there is really no financial privacy, or medical privacy in this country. Habeas corpus has been challenged, as well as Internet privacy is being challenged, so civil liberties have been challenged.

But the combination of business and Government has been ongoing for a good many years. I would say possibly for 100 years, but more so now. And I see what we are doing today, or at least the proposal by Treasury, as a massive move for a lot closer association of business and Government.

Most everybody is aware of the military industrial complex and the combination of how military contractors and Government are in bed together. Now we have a medical-industrial complex. The media is very much involved with Government, as well as just about everything that we have Government and businesses are very much involved.

But the original purpose of our Government was to regulate the Government, not for the Government to regulate the people, because there really is not any authority for the Government to tell us what to do with our civil liberties, or to run our businesses.

I mean, if we believe in the marketplace, the market is supposed to be self-regulating, and there can be a case made for that, but we have embarked for many years in this effort to have the Government do all the regulating. But from my viewpoint, and from the viewpoint of many others, we should be regulating the Government.

We essentially do not. I mean, when you think about the authority—you as the Chairman of the Federal Reserve and what the Federal Reserve can do, I mean it really goes unaudited with very, very little oversight.

Now when you think about the recent embarking of the President's Working Group, this is not an advisory group. It's called a "Working Group." I mean, they are not economic advisors. We have Presidential economic advisors. But we do not have minutes of the Working Group. We do not know what they do. What kind of action—what authority they have.

Once in awhile we hear a report, but we are giving more power to this Working Group. Which means that it looks like we have really given up on the Republic, you know, freedom and the marketplace and sound money. And all we accept is more encroachment of our civil liberties, more collusion between business and Government, and it looks like this is a massive increase in the combination of Government and big business.

So my concern really is very philosophic. I mean, most of us deal here from day to day: Is this regulation good? Is this regulation bad? Without realizing that the general rule is that when Government creates a regulation they create the need for two more regulations. And the same way when we allow our banking system to inflate the economy, it causes the bubbles to occur, and then we have to inflate to prevent them from breaking and, you know, deflating.

So it goes on and on, and we perpetuate our problems. But it seems to me that the basic question that we do not ask, and we should ask, is: Why do we have a business cycle?

For 100 years the conclusion has been in this country, philosophically and practically at the political level, that it is a consequence of freedom, it is a consequence of capitalism. Therefore, we need Government to save the people from their freedom. Freedom of choice personally. Loss of civil liberties and the freedom of choice of businesses.

So could you tell me, do you accept the idea that the business cycle is a consequence of capitalism and freedom? Or is the business cycle, could it be like others who say it's a consequence of Government interference?

Because that to me is the key question. And depending on how you answer that depending on everything we do from here on out.

Chairman Bernanke. Well, Congressman, first a word on the President's Working Group. That is an informal group of the heads of various agencies. It has no separate statutory authority, but it is a chance to get together and talk about issues. And on a number of occasions, as you've noted, we have put out reports that have no statutory authority, but represent our thinking and our staff's thinking on some various issues.

Certainly large parts of the fluctuations in the economy are from the free market. They represent changes in productivity, for example. There are probably also those circumstances in which fluctuations are due to Government intervention—Government spending during wars, for example.

An example which is particularly relevant to the current discussion is that during the 19th Century the United States had periodic financial crises where banks would fail and there would be some effects on the broader economy. And it was dissatisfaction with that that led in 1913 to the creation of the Federal Reserve to try and stop these periodic financial crises.

This created the set of consequences that you allude to in the sense that if you are going to give the Federal Reserve power over the financial system, in a particular, if there is going to be a moral hazard induced by that, then for the protection you need to have some regulation to prevent the moral hazard from creating further distortions in the financial system.

But I do agree with you that fluctuations often have a private-sector entrepreneurial component to it, and we are neither able nor should we try to completely eliminate fluctuations in the economy.

Representative Paul. Is the Federal Reserve contributing to the business cycle?

Chairman Bernanke. It has. It has, in times. Most notably during the 1970s when inflation got out of control and the Fed had to raise interest rates sharply to control inflation, and it resulted sometimes in slowdown——

Representative Paul. Does excessive credit and a low interest rate cause malinvestment, artificially low interest rates that are not market driven?

Chairman Bernanke. The question is, you know, the judgment about where interest rates ought to be. We have of course a mandate for maximum employment and price stability. We are trying to balance those obligations.

So we could make mistakes and put the interest rate at the wrong place, and that would have negative impacts. I agree. So we are doing the best we can to find the right place to put the interest rate, the one that is consistent with the neutral rate or the rate that establishes a full-employment economy.

Representative Paul. And some day we might try the market to determine the interest rates. Thank you.

Vice Chair Maloney [presiding]. Thank you.

Senator Kennedy.

Senator Kennedy. Thank you very much, Madam Chair.

Mr. Bernanke, thank you for being here. We have seen in the recent weeks the widespread breakdown in the financial market that has resulted in leaving 7.4 million Americans unemployed, 2 million families at risk, and they are looking to all of us—to you and to us—for action.

I think that is very much what this Committee is about today.

Now if you look at where we are where we have come from over the period of these past few years since this President took office, the dollar has lost one-third of its value. The Federal debt has skyrocketed by nearly $4 trillion. Our debt-to-foreign Investment has increased by $1 trillion. The stock market has grown at only 2.5 percent each year since 2001, far lower than the 7.5 percent returns it had averaged since 1968.

It has lost $2.7 trillion in value just since last May. And finally, this crisis has wiped out $2.7 trillion in home values in this past year alone. And we could lose as much as $8 trillion before the crisis is over.

So I frequently hear from my constituents who see their hard-earned savings being wiped out. Now I am reading in the papers, in The Wall Street Journal yesterday, that talks about older workers are being forced to put off their retirement because of losses in the values of their home retirement savings.

What can we do to respond to the staggering loss of the Nation's wealth? And how can working families cope with their lost savings and wealth, especially those closer to retirement?

Chairman Bernanke. Well, Senator, the more immediate question is the financial crisis which you asked about. The financial crisis I think is the unwinding of what was an excessive credit boom in the years up through the middle of last year.

For a variety or reasons, global interest rates were quite low and that generated strong efforts to reach for yield as it was said, and so there was a lot of risk-taking. There was a lot of financial innovation, and the result, I think, was some unsustainable investment, some unsustainable asset creation.

We have seen the unwinding of that. That is in some ways positive, but on the other hand, the contraction of credit and the restriction of financing that we have seen associated with that has slowed the economy and has had adverse effects on families as you indicate.

We are trying to find financial stability. The Fed is working the best we can to stabilize the economy and to stabilize the financial system.

From the point of view of the Congress, obviously long-term budget stability and budget balance, wise use of public resources is important. And in the shorter term, as I indicated in a couple of previous questions, I think the critical area right now is housing.

The housing market boom was too large, and it is retracing. That retracing has had implications both in the real economy and also for the financial markets.

There are areas I think where Congress could be helpful on the housing front to reduce foreclosures and to make it possible for people to acquire new homes who are qualified to do so.

So those are some of the suggestions.

Senator Kennedy. Well, and thankfully we have a good team that is working on the housing, and they expect to have some announcements in the next day or so.

But let's go on to your response. What are we going to tell the States? The States are in a critical situation. They are faced with either cutting back in terms of services or increasing taxes. Either is a disaster in terms of cutting back in terms of Medicaid or States increasing taxes which is obviously counterproductive.

What are you suggesting that you are doing to do to help assist the States? And what are you suggesting that we do to try and be a partner to try and help and assist the States so they are not going to have the results of either reduction and significant reduction in terms of services, or also in terms of the taxes?

Chairman Bernanke. Senator, what the Federal Reserve is going to do is try to meet our mandate of establishing a strong growing economy with high employment and price stability.

Senator Kennedy. Well that has been everyone's goal. I mean, we want to hear—I have listened to those since I have arrived and been a Member of this Committee. I mean, we all are interested in that. And we have seen that done. We did that under President Clinton. We had it under President Kennedy. That is the desire.

But we have seen that we are not there now, and just the desire—people want to know now, today. They are going out and fac-

ing these kinds of foreclosures in their mortgages and in their homes and they want to know what to do. The desire to have price stability and economic growth is not going to satisfy them when they go home tonight.

I am asking what we ought to be doing to try and—what is your position with regard to the States? Are you going to provide help and assistance to the States so that they do not have to cut back in terms of services, and do not have to cut back?

Chairman Bernanke. On the States, from the Congress's point of view you are going to have to make a decision about whether you want to provide assistance to the States. That also affects the Federal budget position. That is a decision that is up to the Congress to make.

Senator Kennedy. Yes, but what is your recommendation? Should there be fiscal help and assistance? What is your position?

Chairman Bernanke. That is the Congress's prerogative.

Senator Kennedy. What is your recommendation? We have monetary and fiscal policy. You have responsibility in monetary. Congress does. But in fiscal policy, but you have to have some position——

Chairman Bernanke. No, sir——

Senator Kennedy.—in terms of the economic crisis that we are facing. You are not prepared to tell us whether to try and provide help and assistance to the States that the Administration thinks that we ought to use the fiscal policies that are available to the Administration and to the Congress to try and help and assist families, working families?

Chairman Bernanke. I am all in favor of assisting people, sir, but it is your Congress' decision.

Senator Kennedy. And you do not have a recommendation?

Chairman Bernanke. No, sir.

Senator Kennedy. Let me ask you, just finally, toys and drugs are regulated, and a great many other things are regulated. Should we not make sure that financial products are safe for consumers? Should we not consider having a new agency that is going to review unsafe financial products on the market?

Chairman Bernanke. Senator, it is extremely important. The Treasury blueprint, for what it is worth, has an agency in it that would do that. In the current situation, the Federal Reserve has responsibilities along those lines.

We have just recently taken a number of steps in that direction.

Senator Kennedy. Well let me ask you. To take unsafe financial products off the market, you have that authority now?

Chairman Bernanke. We have some authorities. We have authority to regulate terms of lending on mortgages, and we have set up a new set of rules which would eliminate many of the abuses and problems that we have seen in that area.

We also have authorities relating to credit cards within banks, and we are addressing that issue on a number of fronts as well.

Senator Kennedy. Well my time is just about up. Are you suggesting that we ought to have strengthened power and authority to be able to reduce—to eliminate these dangerous financial arrangements that threaten the wellbeing of the consumer? Do we need that? Do you need it?

Chairman Bernanke. I do not know if we need additional authorities, but we are certainly using the authorities we have to address those problems.

Senator Kennedy. Fine. My time is up, Mr. Chairman, thank you.

Chairman Schumer. Thank you, Senator. And now we have Senator Bennett.

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

I will have a lot of reaction to a lot of the rhetoric we have heard, but this is probably not the time to do it. I will however pick up on one comment that has been made both here and in the press about, well, you have helped out Wall Street, it is time to help out Main Street.

My experience is that Wall Street and Main Street are inextricably linked. Let me give you an example and then get your response to what I see as a particular problem.

We have reached the point in the financial system where a community bank on Main Street has to have a correspondence with a major bank on Wall Street in order to keep things going. And that what happens in the banking system generally permeates down to the very lowest level.

Here is what I am concerned about with respect to the future of the economy. The liquidity crisis is showing up in places that have absolutely nothing to do with housing. Loans that would be made in many normal circumstances—fully collateralized, sound business plan, proper kind of proposal—and the individual, or the corporation that has the loan could very easily be, indeed usually is, a small businessman or small businesswoman. Goes into the local bank, and the banks says: We're not making those kinds of loans because we are trying to strengthen—they do not put it in these terms—but in fact, we are trying to strengthen our balance sheet, add capital to our balance sheet, change our capital to loan ratio which has been damaged by the necessity of our writing down assets that are connected to mortgages.

And the slowdown in the economy that comes as a result of those small businesses being unable to get loans is a consequence of where we are.

Do you have any sense of how seriously that problem is hurting? And if it is hurting, how quickly it might be alleviated?

Chairman Bernanke. Well, Senator, you put your finger on exactly the issue that I talked about in my testimony, which is the credit restrictions that we are seeing right now.

With respect to small business I have heard mixed anecdotes about small business. Not all small community banks have had problems. Many of them were not involved in any way in the subprime lending, for example, and they have not taken any losses, and so many of them are still making loans to local businesses.

But as a general matter, the loss of capital in the banking system—which has only been partially replenished—the increase in the size of their balance sheets as they brought off-balance sheet assets onto their balance sheets, and their concerns about liquidity all are creating a situation where our financial institutions are hunkered down. They are not making loans at the normal rate, and

it is having a real effect on small businesses, on mortgages, on all aspects of our economy.

So I am entirely in agreement with you, and I think that is the nub of the problem. Of course our, the Federal Reserve's actions, have been to try to address that through interest rate policy and liquidity policy.

As regulators we are pushing the banks to raise more capital.

Senator Bennett. How quickly do you think we might get out of this? The lending might become what we would call normal? In 6 months? Nine months? Do you have a guess on that one?

Chairman Bernanke. I think it is tied very much to the progress of the housing market. If the housing market begins to stabilize, as we expect it will later this year and next year, there will be more confidence in the market about the value of mortgages and fewer writedowns and so on, I think that would go a long way to restoring confidence in the financial markets and create more lending.

But I cannot in any seriousness really tell you exactly when that is going to happen.

Senator Bennett. I certainly have sympathy with homeowners who purchased a home on very attractive terms, anticipating that the value of the home would go up and that they might be able to refinance at some point; or taking an ARM that would—in anticipation of circumstances that would be good for them in the future.

I have far less sympathy with speculators who bought two and three homes. I have far less sympathy for those who qualified for what is called a "liar's loan," said their income was higher than it was, for mortgage brokers who encouraged people to do that and told them, look, don't worry because your home will go up.

I do not know any way in which either the Fed or the Congress can by legislation or regulation delineate between those who were speculating and creating the bubble, and involved in liar's loans, and lying about their income, and mortgage brokers that were inflating things, and people who are innocently in homes that they cannot quite handle now.

And if we are to talk about any kind of regulatory or legislative solution for the second group for whom we have great sympathy, how do we avoid rewarding people for their bad behavior in the first group?

Chairman Bernanke. It's a fair question, Senator. There are ways to try to address it. People are supposed to say whether they are going to occupy the home that they own. About 15 percent of all home purchases that we have seen in the last couple of years were by people who are investors, known to be investors. So sometimes you can tell that.

And of course you can always audit people's declarations on their initial mortgages and see if it is consistent with reality when you look to refinance. So it is possible to address those questions, but I agree that trying to separate "the deserving" from the "undeserving" is always a difficult problem in these kinds of programs.

Senator Bennett. The human capacity to speculate and create bubbles goes back to the beginning of the human race. The most

dramatic example we have of it, which I refer to as "Tulip Time" was when people were buying tulip bulbs in Holland.

The tulip is not indigenous to Holland. It was imported there, and people fell so in love with it they would buy a tulip bulb for the purpose of selling it to somebody else for a higher price, who bought it for the purpose of selling it to somebody else for a higher price. And at the end people were mortgaging their farms for the sole purpose of buying a single tulip bulb.

When it suddenly became clear there was no greater fool finally out there to buy the last tulip bulb, the devastation that occurred in the Dutch economy destroyed it for a hundred years. The human capacity to do that with dot com stocks and houses continues to assert itself, and I do not think there is any Government program that could ever stop humans from wanting to do that.

Chairman Schumer. I will refrain from commenting—although you guys are always back in the 17th Century.

Senator Bennett. Actually I think that was the 14th or 15th, whatever.

Chairman Schumer. I gave you too much credit.

Senator Bennett. I'll go look it up.

Chairman Schumer. Congresswoman Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. Thank you for holding this, and thank you again, Mr. Chairman, for being before our Board.

I would just like to associate myself with some of the previous Senator's comments about this whole issue of how Main Street is really integrated with Wall Street.

And having over a dozen years of financial investment banking experience, I found myself just this last week discussing with lots of friends and individuals why somebody like the U.S. Government might want to make sure Bear Stearns is still around, and how it would impact their 401Ks, their home mortgages, their ARMs, and everything all the way to where most people do not realize they might have a stake in something like a Bear Stearns.

But I think they do. And once I discussed it and sort of walked them through some of the issues that they might have with some of their investments and retirements and all, you know, they were pretty surprised. But maybe not so surprised that we had taken some action as a Government there.

So I guess my first comment might be: We need to be better about explaining in layman's terms why some of the actions were taken. Because there are concerns about the housing market, but there were concerns also about what is going on with the markets.

I have grave concerns about what is going on with the market. I will tell you, I have my retirement in that market so I care on a singular basis; I care as somebody who represents people.

One of the concerns I have is that one of the tools you have at your disposal is of course the lowering of interest rates so that banks do have more liquidity, have access to capital, et cetera. But one of the things that I have noticed in the markets in the movements that you have made in bringing down the interest rate is that the market responds of course favorably on the day or the day after that you do this, and then it almost seems like profit takers come in, then sell off when the market has gone up, and the mar-

ket ends up actually lower in a sense even after you have lowered the interest rate.

I have noticed this happening. And so my question to you is: How effective do you think that tool you have is really in the current situation? And I know it is a difficult thing for you to answer. I mean, I have already gone on my Blackberry, the fact that what you said earlier in the meeting to us brought 40 points down on the Index I care about on The New York Stock Exchange.

So I understand that when you speak, people are listening, but how effective do you feel when you are not having the type of impact I would anticipate you would have?

Chairman Bernanke. Well I think monetary policy remains quite effective. It is really a question of saying where we would be otherwise. We have had a very severe financial problem, a very severe restraint on credit. By lowering interest rates and using our liquidity tools, we have generally kept borrowing rates at least no higher. We have at least offset the effects of this credit crunch, whatever you want to describe it, and in some cases we have been able to lower rates somewhat.

So we are fighting against the wind because the forces that we are seeing in this unwinding of the credit boom is making credit more difficult to obtain, and increasing spreads and so on.

But I do believe that our monetary policy actions and our other actions have had the effect of at least offsetting significantly the headwinds coming from these financial factors, and I believe generally providing some stimulus. And I think you have to keep in mind that monetary policy does not work immediately. It works with a lag. So much of the impact of our recent actions may still be yet to come.

Representative Sanchez. And when I see you doing this, and I do not really see the kind of effect I would hope to see, it makes me very concerned about the inflationary aspects of that.

Then we see the high costs of oil and we see the cost of foodstuff in particular in the last few weeks, and I begin to worry about inflation, which is of course something that you first and foremost I believe would be concerned about.

Can you talk a little about what some of the other tools might be in your bag of tricks to help with this, considering that it does not seem to be happening from that end as you are lowering those interest rates?

Chairman Bernanke. Well I think we only have so many general types of tools. We have monetary policy tools. We have liquidity tools, which means lending against collateral.

We are supervisors, and so we have some authority over banks and the like. But we cannot address all the problems, and that is part of the discussion we had earlier today, which is what Congress can do. And Congress can certainly look at——

Representative Sanchez. So this fiscal policy that Congress——

Chairman Bernanke. Fiscal policy is certainly part of it, and just good policy in general relating to trade, and innovation, and education, and all the things that make an economy strong. I mean, those are things only Congress or the private sector can address, not the Federal Reserve.

Representative Sanchez. So how do you feel about us giving a rebate that is not paid for out of the Federal coffers when in fact it is a spending rebate and it is not an investment productive investment, as I would prefer to have seen?

Chairman Bernanke. Well the criteria that I gave for what might be a satisfactory or an acceptable policy included that there might be an effect on the longer term or structural deficit.

We are in a situation where consumers' income is being knocked down considerably by a variety of things, including gas and food prices, as you mentioned. A slowing job market. And a variety of other factors. This is a temporary measure to support their income, and support their ability to maintain their standards of living.

Obviously you cannot do that forever. Obviously you have to balance the budget, or maintain fiscal discipline in the longer run, and I certainly favor that.

Representative Sanchez. Let me ask you one last question.

The issue of the Chinese, the fact that they have increased their Yuan, they're moving their currency, but trade amounts would indicate that in fact it is not enough, and what is the Administration, or what are you doing with respect to this to get them to really have their currency at the level where it should be given the fall of almost 50 percent on the U.S. dollar?

Chairman Bernanke. Well the Chinese currency has been moving now, and moving more rapidly lately, and that is helpful. But the other part of the story is, when we continue to encourage them to be flexible in their exchange rate, but the other part of the story is the reorientation of their domestic economy.

They have a very export-oriented economy. As a result, their own consumers have very high savings rates, very low standards of living. We have urged them, Secretary Paulson and I have visited there. We have urged them repeatedly—and I think we have gotten some good response—to try to reorient their economy toward raising the standard of living of their own consumers, and raising their own domestic consumption, and relying less on exports to get a more balanced economy in the longer term.

That, at least in the rhetoric of the leadership of the Chinese, is something they want to do. And it would certainly make sense for them to try to increase their own standards of living.

Representative Sanchez. Thank you, Mr. Chairman.

Chairman Schumer. Congressman Cummings.

Representative Cummings. Thank you very much, Mr. Bernanke, for being with us this morning.

It was just 5 months ago that you testified before this very Committee that the Federal Reserve had a very positive outlook on the economy. Unfortunately, since November 2007 the situation appears to have gotten incredibly worse.

Foreclosures have risen, home values are falling. Many of the people in my district and throughout this country, are paying a lot more for food, for gasoline, and they tell me that when you speak, a whole lot of people listen.

I'm sure there are people sitting around televisions right now, trying to figure out, will you say something that will give them a sense of hope and give them a sense that things will get better?

There are people who can't even afford the gasoline to get to their jobs. And so I'm not here to be very critical with regard to the Bear Stearns situation. I think I can kind of understand that.

I understand that we have to make sure that these large companies like Bear Stearns succeed, but I'm more concerned—first of all, I want to know, do you see more Bear Stearns situations down the pike?

I know—I've heard what you've said about you hope that that doesn't happen, that you all are looking at things very carefully, but do you see that coming down the pike?

Chairman Bernanke. I don't see any situation like that at the current time. One can never tell the future, but I—you know, currently, I think that our measures to increase liquidity in lending, and our macro policies, are being helpful, and so at this point, I don't anticipate a similar situation arising.

Representative Cummings. And if—and, you know, as much as I care about companies like Bear Stearns, I'm very much concerned about us not letting the United States citizens down.

You know, we talk about the failure of a company like that, but it's also important that we don't let our citizens fail, either.

And you have said over and over again today—and I was just intrigued by your answer to Senator Kennedy's questions about States, what the States—how you would—what recommendations you would have for us to try to help the States.

But I'm just wondering, are there—you—but you continuously talked about things that we in the Congress—you say we—it's up to you; you've got to do it.

And, you know, if you had three major things—I mean—and I know it's up to us. But you're the expert. You're the one that we depend on. You're the superstar, and I'm very serious about that.

So we come to you and we say, what is it? I mean, I'm just asking you for three or four things that you would love to see us do, that would help, I mean, help this situation.

Let me tell you something: I mean, people listen to this, but the people in my district, they're trying to figure out how this is going to affect their gas prices. They're trying to figure out—I mean, or their—at least their ability to pay for it.

How is this going to affect their ability to pay their mortgages? I mean, this is real.

How are they—you know, when I think about the economy, you know, I've got people who are saying they're not going—they're not driving much anymore. And you know what that means when they don't drive much anymore? A lot of those fast food stores and shopping centers, they don't get the business.

So, I mean, it's all connected together, and I'm just wondering, what would you like to see us do, or what would you recommend to us?

Chairman Bernanke. Well, Congressman, I've talked about lots of different issues, and I think there is a short-run versus long-run question here.

As I said in my testimony, I have great confidence in this economy in the longer term. We're going through a tough period. I think we're going to do much better. I think we're going to continue to grow at a healthy pace.

How can Congress help that? I've talked about fiscal issues and fiscal discipline. I would add to that, education is critical, to get people to have the skills, so that they can earn sufficient incomes.

And energy, as you mentioned—you talked about gas prices. You know, we need to have better research, and we need to have cleaner energy, we need to have better structured regulations that allow alternative energy to take its appropriate role in the economy.

So there are a lot of long-term things that can be done, that would help this economy grow and be strong, and, you know, deal with the coming challenges of an aging population that we face.

In the shorter term, we are facing some very difficult challenges, both in the financial markets and in the real economy. I appreciate your comments about Wall Street and Main Street.

I think, as I said earlier, we address the financial problems, because we think they affect Main Street. We think they affect ordinary people, and that's why we're concerned about it.

From Congress's perspective, as I've noted a couple of times, there are not obvious solutions. You've already taken some steps like the stimulus package, but I think the general area where, as you mentioned yourself, the most serious problem that remains is in the housing area.

And to the extent that you can come to agreement among yourselves about ways to improve the mortgage markets, so more people who want to buy homes, are able to buy homes, and so that unnecessary foreclosures can be prevented, so to avoid putting more houses on the market, because people lose their houses, that's the general area in terms of the short run, that I would be most encouraging that you look at.

Representative Cummings. Do you think we went far enough with regard to the stimulus package?

Chairman Bernanke. I think it's a quite adequate package for now, yes.

Representative Cummings. And when do you think we'll see some impact from that?

Chairman Bernanke. We should see impact on that—it's very hard to know for sure, of course, and the size of the impact is uncertain, but I think the checks are going to start going out, I believe, next month.

Representative Cummings. Right.

Chairman Bernanke. So we should start to see some effect by, you know, another month or 2.

Representative Cummings. And so you just don't know, you can't predict the significance of the impact?

Chairman Bernanke. Well, it's likely to have an impact, because most of the money will eventually be spent, but the timing is a little bit unsure, a little bit uncertain.

Representative Cummings. Thank you, Mr. Chairman.

Chairman Schumer. Thank you, Congressman Cummings. Congressman Hinchey has come in, but he's going to get his—look over what was asked and not, so we'll begin our second round, and we'll go to Congressman Hinchey whenever he's ready.

So, I would just like to go back to this issue of the Main Street versus Wall Street, as it was aptly put.

And I know my colleagues on this side, have said that Wall Street's connected to Main Street. Of course it is, and I don't hear anyone saying we shouldn't have—you shouldn't have done what you did with Bear Stearns. They might tweak the dial a little bit.

But the reason you did it—and, let's face it, it will help some people, not maybe the shareholders, but bondholders and others at Bear—was not to help anybody who had anything to do with Bear, but, rather, because of the systemic risk that it presented, the potential for real dramatic systemic risk, and that's correct.

But the housing market presents, in macro, the same systemic risk. And one of the things we're always up against, if you're very big, you get helped, and if you're very little, you don't, but we're not saying just help one individual homeowner; we're saying, help the macro housing market.

And so I'm a little—I'm not asking you to choose a policy, but we do have with this Administration, a full-fledged support of helping the big guys, on the basis of systemic risk, but not the little folks.

And you know, there's trickle-down and there's trickle-up and some of each actually happens in the economy. Part of it is an ideological perspective.

Isn't it reasonable to ask for intervention in the housing market, on the basis of systemic risk, just as it's reasonable to ask for intervention in the financial market?

Chairman Bernanke. Again, Senator, I supported housing actions. I think about it a great deal. My own analysts work on many——

Chairman Schumer. I know.

Chairman Bernanke. But the difficulty is not obvious, exactly what the most effective policies are, and that's an issue.

Chairman Schumer. That's true in financial markets, as well.

Chairman Bernanke. That's true, as well. So, all I can say is that I do support efforts to try to improve the housing situation. I think it is critical to the current situation.

Chairman Schumer. Do you think the Administration's view on housing, has been adequate?

Chairman Bernanke. I can't answer that question. All I know, is that I have talked extensively with members of the Administration, and, obviously, there are concerns there, and we've discussed possible options.

Chairman Schumer. I'd urge you to quietly and not in front of all of us, continue to prod them to do more, because they seem to have these ideological handcuffs that have no real distinction.

Let me go to the next question. With regards to the $29 billion that the Federal Government guaranteed in the Bear Stearns-J.P. Morgan Chase deal, how concerned should the U.S. public be, that taxpayers will be left holding the bag? How confident can we be that these assets won't decline in value?

Chairman Bernanke. Well, based on our valuation by our investment advisory firm, based on the fact that the prices, the Bear Stearns prices were based on an illiquid market and we are able to sell the assets over an extended period of time, based on the fact that we have a $1 billion first lost provision from J.P. Morgan——

Chairman Schumer. That's why I said 29 and not 30.

Chairman Bernanke. It's $30 billion of assets.

Chairman Schumer. Right.

Chairman Bernanke. And $29 billion of money at stake.

You know, I can't tell the future, but I feel reasonably confident that we'll be able to recover all the principal, and, indeed, some interest, and there is some chance of even upside beyond that.

Chairman Schumer. Chrysler. They made money on Chrysler. You can ignore that.

One of my major concerns has been the opaque nature of the derivatives markets, particularly credit default swaps. One of the places I disagreed with Treasury Secretary Paulson, when he talked about restructuring, was that he didn't mention those instruments.

We've got these complex instruments. Some of the CEOs of the companies that trade in them, told me they don't know—they don't really understand them. Counterparty risk that these instruments can create is greater than anyone ever expected and can threaten the stability of the financial system, even if they are held by a rather small entity, because of the ping-ponging effect.

They're entirely unregulated. Now, we certainly have a difficulty, if we regulate them here. They can just go to London and nothing will change, so we have to deal with this on an international basis.

But do you agree that we need to bring credit default swaps and other derivatives, in some way, more under our regulatory tents, certainly in terms of transparency?

Chairman Bernanke. Well, some derivatives are traded on exchanges.

Chairman Schumer. Yes.

Chairman Bernanke. And those already have various controls and measures. For over-the-counter derivatives, which are bilateral agreements, in almost all cases, one of the parties involved, is a regulated institution, and so perhaps in some cases, the best way to address the issue, is to make sure that the parties involved, have good information and clear understanding of what their risks are and what the counterparty risks are and the like.

Chairman Schumer. They didn't in mortgages. It may be a bit naive to assume or be presumptuous, that they know it about these complex instruments.

Chairman Bernanke. So we need to do better on that. But there is a natural life cycle of these instruments. Some of the start off as bilateral, over-the-counter, and as they become more standardized, then they move to an exchange.

In the case of credit default swaps, the Federal Reserve Bank of New York, as you probably know, has been working very hard to try to improve the clarity of the trading process, the recordkeeping process, and the like, and try to avoid problems, try to develop new protocols like the cash-basis protocol for CDS resolution.

So, you know, we're moving in the direction of more and more information on these things, but you can't go from zero to 60 immediately.

Chairman Schumer. Sure, but you think there should be some move in that direction? I'm not asking you to specify how much.

Chairman Bernanke. Well, I think, at a minimum, that those institutions which use these instruments, need to be—obviously,

need to understand what they're doing, and they need to have clarity for the supervisor, as well, on their positions.

Chairman Schumer. OK, good. One final question: When you appeared last November before this Committee, you said that businesses appear to enjoy relatively good access to credit, despite the emerging problems in the credit markets.

Given the deterioration of credit markets over the last few months, would you say it's still true that businesses enjoy good access to credit? Can a business outside of the financial sector, get access to credit it needs to make necessary investments?

Chairman Bernanke. Senator, yes, as I indicated in my testimony, some high-grade corporations, you know, with high ratings, are still able to get credit. Investment of high-grade bonds, has not actually declined very much, and, moreover, those firms have a great deal of internal cash and other resources.

Chairman Schumer. Right. I've heard from commercial real estate people, even triple-A types, that they are having real trouble.

Chairman Bernanke. So, my answer was responsive to corporations, non-financial corporations. Lower quality non-financial corporations, so called high-yield issuers, and, on a more mixed basis, small business—my answer to Senator Bennett, which depends to some extent on the circumstances of the individual company, have done less well and have more restrictions.

We are certainly seeing less credit available for commercial real estate, in particular, commercial mortgage-backed securities are almost—none of them are being securitized at this point, which is a drain of an important source of capital that had been flowing into commercial real estate.

Chairman Schumer. So, does this present real worries to you about the future in our economy?

Chairman Bernanke. Well, it does suggest that as we look at the forecasts, that last year's very rapid increase in nonresidential construction, is unlikely to be repeated, in part, because of a slowing economy, but, in part, because of a tighter credit situation.

Chairman Schumer. Are you ready, Congressman Hinchey, or do you want me to go to Senator Brownback? OK, Congressman Hinchey.

Representative Hinchey. Well, thank you very much, Mr. Chairman, and good afternoon, Chairman Bernanke. It's always a pleasure to see you. I apologize to you and to our Chairman, for not being here on time. I'm sorry I missed the early part of this hearing.

But I again want to express my appreciation to you, not just for being here, but for all the things that you're doing.

Recently, I had an opportunity to have a conversation with the Secretary of the Treasury, Secretary Paulson, and we talked about the economic circumstances. And I asked him what he thought about the prospect for a recession. I think that, in fact, we were in recession, and I have thought that for some time now.

He responded by saying, no, he didn't think we were in recession, nor did he think we were heading that way.

But I understand, based on what I've heard recently, that you think that there is that prospect, that we seem to be heading in that direction, and I think that statement is also strengthened in

the basis of what's been done, in terms of reducing the interest rates.

I think that the reduction in interest rates and other actions that have been taken by the Federal Reserve, have resulted in the lack of a strong decline in the stock market, and I think that your actions, once again, have begun to strengthen that market up a little bit again.

But I think that that is likely to be temporary, and I'm very much concerned about what is going to happen over the longer term, like over the course of the next several months.

Do you share that concern?

Chairman Bernanke. Well, let me be precise about what I said about our view of the forecast. We're currently in a period of slow growth that began in the fourth quarter of last year.

We expect it to continue through the first half of this year. It's possible—not certain, but possible, that the first half of this year will be slightly contractionary. That doesn't necessarily mean that it's a recession, because it would depend on the circumstances, and the NBER makes those determinations, well after the fact.

At this point, we are expecting better growth in the second half of the year, in part, because of the monetary and fiscal stimulus, which is already in the pipeline, so that's kind of the outline that we have currently.

Of course, it's very provisional. We're going to see how things evolve, but there's no question that the first half of 2008 is a slow period for the economy.

Representative Hinchey. I think that it's very typical of the Federal Reserve to focus its attention on the larger aspects of the financial market, and to deal with issues such as the one that you've dealt with recently, which has prevented the financial collapse of Bear Stearns.

I think that that had a positive effect on the market. But what concerns me, is my personal interaction with people and the way in which the economic circumstances are affecting the average person across the country, middle income, working class Americans.

The credit card debt has gone up dramatically, something above 11 percent, close to 12 percent now, and it's increasing; it's going up even more as time goes on.

The personal bankruptcy rate has gone up something in the neighborhood of 15 percent, just in the last month or so. All of this is being driven by a number of things, including the cost of living and the downturn in income for working people.

And as we all know, the gross domestic product, at least two-thirds of it, is driven by consumer spending, and if consumer spending continues to be affected as it has—and the evidence indicates bankruptcy, credit card debt, decline in income, increase in the cost of living—it seems to me that the gross domestic product is going to be severely affected.

We haven't really addressed that problem, we haven't really focused on that aspect of the economic circumstances. It seems to me, what has been done, has an element of superficiality to it. It looks at the top, but it doesn't deal with the base.

And I think that this is something that we need to do, and I, of course, appreciate your opinion, your views on these things, and I

would be deeply grateful to you for telling us what you think about what we should do to help the gross domestic product, middle-income people. What's going to happen if that continues to drop the way that it has, when all the indications are that it will?

Chairman Bernanke. Congressman, I absolutely share your concerns about the average person's situation in terms of their income, in terms of the cost of living. I think that's really what we're all here for.

That's what the Federal Reserve is about, that's what Congress is trying to achieve, improvements in the standard of living. I think it's useful to try to separate the short-term and the long-term.

Part of my reason for thinking that growth will be somewhat better, going forward, is that we have taken some pretty strong efforts to stimulate the economy, including both monetary and fiscal policy.

I have some hope that the financial situation will begin to improve and the housing market will begin to at least stop declining in the way it has been, and all those things together, suggest some improvement later this year.

As I indicated earlier, in terms of what Congress can do, I think that as far as the near term is concerned, that the housing market should be the focus, because that's where the center of the problem is.

In terms of the long run, I don't want to—I know it sounds like cliches, but, you know, our long-run economic health depends vitally on things like people acquiring adequate skills.

My wife is a teacher and she's been trying to start a school for inner city kids. She's very concerned about the dropout rates and about the low skill levels of people who don't get enough education.

I share that concern. I think that's incredibly important. I think it's very important for us to try and improve our energy situation. There are ways that we can do that.

So there are a number of things we can do to try to improve our long-run prospects, and we should be operating both on a short-run and on a long-run timeframe, simultaneously, as best we can.

Representative Hinchey. I appreciate that, and I think you're absolutely right, but I don't see it being done. We're not doing anything that addresses the issues that you just raised.

The issues that are being addressed by the Federal Reserve, and, to some extent, appropriately, are the ones that we've talked about, and which have gotten a great deal of attention across this hearing, but the fact of the matter is, what's driving the economy is sinking down.

I think we're in a recession now, I think we've been in recession for some time, and I think that that recession is going to continue to get worse.

The housing situation that we're confronting, is not what's driving the recession; it is a function of the recession; it is a result of the other recessionary aspects of the economy, the driving down of the ability of the average person to deal with their economic needs on a regular, daily, weekly basis.

So, I don't think it's important for us to think that the economic downturn that we're experiencing, is being driven by the decline in the housing market. The economic downturn is driving the housing

market down. It's a function of a downturn, not the activity that's driving it.

So I don't think we should be confusing ourselves about what's really happening here.

Chairman Schumer. Senator Brownback.

Senator Brownback. Thank you, Mr. Chairman. Thanks for staying for another round, too.

I appreciate your wife teaching and concerned about the human capital formation. My oldest daughter is teaching, doing the Teach for America Program in Houston, and teaching seventh grade math, which are probably two topics that should never be blended, seventh grade and math.

[Laughter.]

Senator Brownback. And it's just tough, and it's tough to teach and it's been a difficult environment. I do think we've got to expand our support of the family structure in the country, as one of the key building blocks of where you form that human capital, but that's not something the Fed's working on.

You've said a couple of things earlier that I just wanted to follow up on. You learned a day before Bear Stearns was going to file for bankruptcy, and that's what clicked in this extraordinary set of things.

And, apparently, that information was new information to you, a day ahead of time, that they were going to have to file for bankruptcy. You stepped in, did extraordinary actions, and now you've got more people placed with some of these major firms, apparently getting information, that the regulators are needing—regulation changes slowly, financial markets change rapidly.

I'm just curious. What information are you looking for now from these big financial institutions, to make sure that the next one isn't a big surprise?

Chairman Bernanke. Well, we're looking—of course, our authorities differ in terms of the bank holding companies for which we have, you know, statutory supervisory responsibility, versus the investment banks, where we are cooperating with the SEC and with the companies on a voluntary basis, because they have access now to our window.

So, there's somewhat different responsibilities and authorities in those two cases. But, clearly, we're looking at asset quality and capital; we're looking at liquidity; we're trying to make judgments about managerial risk management, earnings quality, a variety of things that we look at to try to ascertain whether a financial institution is sound or not, and, if not, you know, we need to push them to improve their processes, to raise capital and improve their liquidity.

Senator Brownback. Now, you mentioned on Bear Stearns, that it wasn't a capital problem; it was a liquidity problem, so is liquidity the primary issue you're looking at now?

Chairman Bernanke. I think you need to look at both. There's always an interaction. Liquidity tends to dry up when people have concerns about capital, that is, about solvency.

But in the current situation that we have, it is possible for liquidity to be withdrawn, based on less than solid information, and

so we think both the capital and liquidity are important for stability.

Senator Brownback. But you're getting more information now.

Chairman Bernanke. Yes.

Senator Brownback. Are you concerned about the information you're getting? I mean, are you looking at any of these situations and saying, OK, I've got some concerns developing in this or that category? For instance, with UBS, should we read anything into that? Seeing needs for additional capital?

Chairman Bernanke. Well, UBS is an example. I mean, we were aware of their problems for quite awhile. They, however, are a Swiss domiciled bank, and so the Swiss took the primary responsibility. Of course, we work with the Swiss, because they have extensive operations in the United States.

The appropriate response to their losses, would be to raise capital, and, indeed, they did, and that was, in fact, very encouraging, that they were able to go out and raise a substantial amount of capital, and that's exactly what we would urge any institution that was in trouble, either to raise capital or to somehow get itself acquired. That would be our general approach.

Senator Brownback. Did the Swiss Central Bank push them to raise capital?

Chairman Bernanke. I'm sure—and I'm not speaking now with—you know, I don't want to reveal any confidences or speak, you know, out of turn, but as a normal course of events, the supervisors of a bank in Europe, just as in the United States, would be, you know, very much interested in the ability and willingness of the company to raise adequate capital.

Senator Brownback. So that they would have been tracking the situation for UBS, and suggesting, OK, you need to get more capital?

Chairman Bernanke. Certainly, as we were doing here in the United States.

Senator Brownback. But the Bear Stearns situation jumped up on us rapidly. Was that because of a lack of information, or that there was just a run on the institution?

What I'm trying to figure out, is, is there another shoe to fall here sometime soon, or is it that we're—OK, we think this was an unusual situation with Bear Stearns, and we're not seeing the same sort of factors lining up with any of these other big financial institutions?

Chairman Bernanke. I don't see those same factors lining up. The fact that we're now lending to the dealers, I think, will be of some help on the liquidity side.

But, obviously, you know, the future is never certain, and we're going to have to be vigilant, as we go forward.

Senator Brownback. And the central bankers, it looks like to me, are going to step in at an earlier phase now, with what happened with Bear Stearns, to push for capital, liquidity, to prevent this setup from happening again, like what happened with Bear Stearns?

Chairman Bernanke. Well, Bear Stearns was very unusual in terms of how quickly things deteriorated. Again, I would defer to some extent to my colleagues at tomorrow's panel, Senator Dodd's

hearing, who will be able to give much more detailed information about what was seen, when, on Bear Stearns's books, so we will be able to provide that information to the Congress.

Senator Brownback. Is our economy shifting now? The last questioner, I thought, had some interesting points about the consumer debt, which we've been concerned about for a long period of time.

Are we shifting away from as much of a consumer-driven economy, more toward exports or other pieces for our gross domestic product?

Chairman Bernanke. There is one, I think, very encouraging trend, which is the increasing competitiveness of U.S. exports and the extent to which our firms are selling and competing internationally. Our net exports have been a major source of our growth that we've had recently, and we expect it to be important in the next year or two, as well, so that is a positive from the point of view of our economy, and it will obviously affect our trade deficit and reduce our need for foreign finance and so on.

Senator Brownback. Thanks, Mr. Chairman, thank you very much.

Chairman Schumer. Thank you, Senator Brownback.

Congresswoman Maloney.

Vice Chair Maloney. Thank you, Mr. Chairman.

Chairman Bernanke, the real estate bubble and financial crisis in Japan, led to a lost decade where the economy saw very little economic growth.

In a piece in Monday's Financial Times about this lost decade, they described Japan's lawmakers as having waited until 5 years after the collapse of Japanese financial markets in 1998, before approving the use of public monies to rescue banks and other key financial institutions.

This delay is now widely believed to have prolonged Japan's credit market distress. Many economists now think that we are already in a recession, and Martin Feldstein has warned that this recession could be, and I quote, "Substantially more severe than recent ones."

What would be some of the signs that monetary policy is not working?

Chairman Bernanke. Well, if the economy were to continue to worsen, the financial markets were to continue to worsen, obviously, that would raise concerns.

The Japanese case is interesting, because it does demonstrate that financial factors do matter for Main Street, so to speak, but in that case, there were some important differences, notably the Japanese banks hid their losses for many years, and even though they were functionally insolvent, it was not evident in terms of their bookkeeping, that they were.

Eventually, it became necessary for the Government to bail out those banks. Our banking system is much more open in terms of describing its financial condition, and while many banks certainly have taken losses and there have been problems, it is, on the whole, very solvent and has a high level of capital, and so we're nowhere near the situation that Government bailouts are needed for our financial system.

Vice Chair Maloney. What conditions would have to exist to warrant a second stimulus package?

Chairman Bernanke. Well, again, if we go into next year and the economy continues to be weak and monetary policy is not being effective, if financial markets, for whatever reasons, are not improving, then that would be a time to look at alternative options.

I think, for the near term—and, again, I'm not addressing issues like home ownership and many other things that Congress may want to deal with, but simply in terms of the fiscal stimulus package that was put in place, it's a fairly significant package, which should add something like a percentage point or even a little more to growth in the second half of the year.

I think we ought to—on that particular issue, I think we ought to give that some time to work, before we take additional steps.

Vice Chair Maloney. OK, you say next year, not the third quarter?

Chairman Bernanke. Well, we won't know with real certainty, about the implications of the fiscal package, that quickly. It will take a bit more time than that.

Vice Chair Maloney. And given the potentially long-term nature of this slowdown, should we focus on more long-term investments such as infrastructure? That was a debate that we had in the first stimulus package, and, obviously, education.

Chairman Bernanke. Well, I draw the distinction. When I talked about the stimulus package, I talked about timely and targeted, using the language that Larry Summers and others have used, which meant that, for the purpose of stimulus, it was important to have things that could be enacted very quickly and take effect very quickly, and would have a high bang for the buck, so to speak.

In many cases, not necessarily in all, but in many cases, infrastructure takes a long time to plan, to put into process, and it's a while before it has an effect.

And so, generally speaking, infrastructure projects are, at least, you know, over a short period of time, are probably not the most efficient way to provide fiscal stimulus.

Now that's not to say that infrastructure is not important, and Congress may well decide that, in light of our needs in the long term, that we need to be doing more on that front, but I think that that would be based on an analysis of our long-term needs, rather than in terms of short-term stimulus.

Vice Chair Maloney. And how do we avoid waiting too long to avert a deep or prolonged downturn in our economy?

Chairman Bernanke. Well, you know, there are risks in both directions. You could also overstimulate and have the economy exceed its capacity and add to inflationary pressures, and so I know of no alternative, than to continue to be vigilant and do our best to forecast where the economy is going, and to watch financial conditions and to check back frequently.

Vice Chair Maloney. And, finally, my last question, because my time is almost up, but the American Banker talks about the proposal to increase the Fed's powers, and they talk about that with these powers, there will be a call and a need, really, for increased transparency.

And they describe the Fed as the most secretive of agencies, yet when taxpayers' money is being put at risk—taxpayers will really want more information about the risk to their dollars. We heard many questions about the Bear Stearns risk involved there.

Do you agree that if the Fed is given more power to use taxpayers' money to help non-banks, that there is an obligation that more of the proceedings of the Fed should become more transparent? This is a question that Mr. Paul was talking about earlier.

And we've all been curious, obviously, today, about the Bear Stearns crisis, for example, and do you agree that taxpayers should know how much risk the Fed is taking, as it moves into this new area, particularly since it's taxpayer money that is now being put at risk?

Chairman Bernanke. Well, to be clear, Congresswoman, the financing that we did for Bear Stearns, is a one-time event that has never happened before, and I hope it never happens again.

We do lend, on a collateralized basis, to other facilities, but we do so with lots of security. And, as I said, as far as I know, we've never lost a cent, so it is not our intention, on anything like a regular basis, to be putting taxpayer money at risk.

The powers that the American Banker is probably referring to, probably have to do more with regulatory and supervisory powers, rather than with fiscal types of issues.

I'm all in favor of transparency. I think the Congress needs to know what we're doing, why we're doing it, and I'm happy, either individually with you, or in hearings, to explain our reasoning and to make sure Congress is satisfied with our performance.

Vice Chair Maloney. Well, thank you for your testimony and for your service.

Chairman Schumer. Congressman Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman. Once again, thank you, Mr. Chairman.

And I think, especially, it's impressive, the innovation that you expressed in stepping into the Bear Stearns situation. As you just said, this is something that has never been done before, the way that you engaged it in this particular circumstance, and I think if you hadn't, then there would have been a likely serious impact on the economy in very obvious ways, including the stock market, generally.

So, that was in that sense, I think, a very good thing that you did.

But I continue to be deeply worried about the future. My sort of analysis is—but it's more of a guess, basically—is that this economy is going to continue to get worse, and that 6 months from now, we may see it in a very, very bad situation.

And I say that, based upon what's happening to the average people in the economy and the difficult circumstances that they're experiencing and the evidence that pops up day after day.

For example, the recent indication of the dramatic increase in food stamp use, that, of course, is driven by the rise in the cost of food. So more and more people are using food stamps. That seems to be not just at a level now. It seems to be continuing to go up.

So that just is another indication of how so many families in this country are finding themselves in very difficult and very, very challenging and dangerous circumstances.

And the impact on this inflation, is something that is basically not being driven internally; it's being driven externally by the price of energy and the price of food, driven externally.

So we have a hard time really addressing that, unless we begin to be creative, like, you know, new alternative energy sources and things like that, which we're being very casual about. We should be much more aggressive about that, and it just shocks me continually, that that causality continues to exist there.

But the basic problem we're facing and which needs to be addressed, I think, more by the Congress than by the Federal Reserve, but with the Federal Reserve and with the Federal Reserve's advice, is to deal with the economic circumstances that are being confronted by the average family across the country.

And those two prices are going to continue to go up, given every indication, and, if they do, the cost of living is going to continue to go up, and the quality of life in our country is going to continue to go down.

And as that goes down, it's going to have a direct major impact on the growth of the economy, and, at some point, it may hit very, very hard.

So I would appreciate the ability to work with you, to get some advice from you, to get some insight, additionally, over that which we already have, into what is exactly happening here.

And if you would be kind enough now, maybe to express some of that to us, I'd be very grateful.

Chairman Bernanke. Well, Congressman, first of all, I'd be happy to meet with you individually, if you'd like.

You point to a very important problem, which is that globally traded commodities, including energy, food, and many other things like metals, for example, for a variety of reasons, including the increased demand among the emerging markets, those prices have gone up a lot.

That's a huge challenge to us as an economy. On the one hand, it's inflationary, it creates those pressures; on the other hand, it reduces standards of living, it affects consumer spending, and that causes the economy to tend to slow, so that's the most difficult challenge that the Federal Reserve faces, certainly, is to deal with those kinds of shocks.

You know, I wish I had a simple answer for you. In the longer term, the one small silver lining in hundred-dollar oil, is that lots of alternatives become economically feasible or economically profitable.

Over a period of time, I think many of those alternatives, particularly if Congress supports them with research and wise regulatory policy and so on, that they will become available and will make a difference.

Unfortunately, many of these alternatives have long lead times, and we can't expect to have them available within a year or two, and so we're in a period right now where we're essentially having to deal with the implications of very high energy costs, while hoping and waiting for alternatives to become available.

So it's a difficult period, and I hope that I don't convey a lack of sympathy. I certainly understand the problems that people are facing, and everything we do, is an attempt to try to improve the welfare of the average American.

Representative Hinchey. Yes, I understand that, and I very much appreciate it.

The conversation that you and I had back in November at the hearing, included the issue of stagflation, which is an issue that, peculiarly, confronted this economy several decades ago.

And it seems to me, the closer I look at it over a period of time, the more likely that we're going to be confronted with that problem again, because the two elements of it are very much in force.

The cost of living is going up, and although it's not always shown in the inflation rate, but the fact is that the cost of living is going up dramatically and it's not likely to improve. This forecast of $4 a gallon of gas by the Summer, if that happens, that's going to be a very, very tough one to deal with.

And at the same time that the economic circumstances, the income, spending ability of middle-income, lower-middle-income working class Americans, continues to be stagnant and/or declining, so it seems to me that this is a real problem, and that we're going to have to be really creative and effective in trying to deal with it.

So, if there's any response that you would like to give to that, I would be deeply grateful to you.

Chairman Bernanke. I agree it's a very, very tough challenge. I think we need to think hard about our energy policy, we need to make sure that there's adequate research. We need to make sure that alternatives which meet environmental requirements and other requirements, are sensibly regulated, are allowed to be used, if they are effective and meet environmental requirements.

And we need to encourage both private and public efforts to find alternatives. I think that's very important.

Again, unfortunately, it's not going to happen in the next 6 months; it's going to take some time, but I do believe that at this price, that there are a lot of alternatives, including conservation, of course, to crude oil.

Representative Hinchey. Well, I don't think those things, those issues, are going to address this issue in the way that it needs to be. We need to come up with something much more effective, much more strong than what we've come up with so far.

Thank you very much.

Chairman Schumer. Thank you, Congressman.

Well, Mr. Chairman, I want to thank you for being here.

You've been the Chairman for 2 years; you're getting the knack of this. Carolyn Maloney and I were commenting to one another, that we really appreciate your forthrightness on these issues, and you're very forthright, but when you can't go over the—you can't—you get up to the point that you can answer, and then you stop, and that's probably what you should do.

I just have one final statement that I'd like to ask your comment on. It follows up on what Congressman Hinchey was talking about, particularly in his first round.

So, I'm going to make this statement and then you just comment on it, and that is for the last 10 to 20 years, America is like a giant, strong giant, who's getting very overweight. We import more than we export, we consume more than we produce, we borrow more than we save.

And while one couldn't guess where the financial problems and crisis would occur, when you do that, they certainly occur. No one would have predicted mortgages, even 3 years ago, but maybe that's less relevant than the fundamental imbalances that we had in our economy, and, sooner or later, the chickens would come home to roost, even though we couldn't predict where.

Would you comment on that?

Chairman Bernanke. Well, I think there are a number of factors at work in the current situation—some short term, some long term. But I think that achieving greater balance over the longer term, is extremely important, and all the areas you mentioned, I basically agree with.

Chairman Schumer. Thank you very much.

Chairman Bernanke. Thank you.

Chairman Schumer. The hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

Submissions for the Record

JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER, CHAIRMAN
REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER, CHAIRMAN

Well, Chairman Bernanke, we want to thank you for joining us today in what will be your third appearance at the Joint Economic Committee during this term of Congress.

And of course you're here to talk about the economy. Not just housing, not just the financial markets, and not just the regulation of those markets. The economic news continues to be alarming—whether it's employment, inflation, housing, financial industry turmoil, or consumer confidence.

Last month you looked into the precipice of financial meltdown and acted. It is hard to disagree with the need to take quick and dramatic action to spare our financial system of the risk of the kind of meltdown we saw in the Great Depression. Those who in retrospect say they wouldn't have acted, in my judgment, are showing an unfortunate degree of intellectual arrogance and maybe even some disingenuousness. To look into the abyss of imminent financial collapse as a potential and do nothing is irresponsible.

Your actions to rescue Bear Stearns provided some much needed breathing room to the financial markets—for now. *But there are many legitimate, looming, and unanswered questions about the before and the after. What happened both before and after the Bear Stearns action.*

On the before—as early as last summer, there were warning signs that Bear Stearns was in trouble when two of Bear's hedge funds—funds that were heavily invested in subprime mortgages were forced to declare bankruptcy. At that time, were the members of the Fed concerned about the long term viability of Bear Stearns? Did you receive any consultation from other agencies like the SEC? If you were concerned, did you take any actions behind the scenes to help shore up Bear's tenuous position? And if not, at what point did you know that Bear Stearns was in serious jeopardy? What action did you take at that point? Could earlier, more aggressive action by the Fed, by the SEC, or some other agency have saved Bear?

And the after—in the wake of the Bear Stearns' debacle, a number of concerns have been raised about the precedent that the Fed's actions set for other Wall Street firms. In order to avoid a similar future situation, what actions has the Fed taken to deal with a possible similar situation? Do you now have established criteria for when intervention is appropriate? To avoid a future Bear Stearns' situation, do you expect the Fed and the SEC to be more proactive in protecting investors from a potential Bear-like situation?

Now, maybe if we had a single financial regulator, this wouldn't have happened. Imagine how much better off we would have been if a strong regulator who could have called in Bear Stearns far earlier and forced them to take steps that would have prevented the disaster we confronted 2 weeks ago how much better off we would be.

And there are serious questions about housing as well and many people juxtapose the action that was taken in regard to Bear and then not taken with regard to housing. What is the justice of helping Bear Stearns and not millions of homeowners? A single homeowner going under does not pose systemic risk as Bear did, but millions of homeowners going under do. I worry that as quickly as the Federal Government moved to save Bear Stearns from complete failure, it has moved at a snail's pace, if at all, to save homeowners from foreclosures. The administration was all for government action in the case of Bear Stearns, but what about government action to help homeowners? Yes Bear Stearns was in trouble, but millions of homeowners are also in trouble. Yes Bear Stearns needed government intervention, but what about government intervention for homeowners?

I'm hopeful that this week the Senate will redouble its efforts to respond to the housing crisis by passing much-needed legislation. And while I know that you don't take positions on specific legislation, no Fed Chairman does and the Fed Chairman shouldn't in my opinion, *I hope that you will privately use your influence to convince those in the Administration that this modest effort is needed to bolster homeowners and the economy.* We will hopefully get bipartisan support for the Foreclosure Prevention Act, which, among other things, would:

- Add $200 million in pre-foreclosure counseling funds which could help 500,000 families keep their homes; and strengthen the housing markets and the economy, and
- Provide $4 billion in Community Development Block Grant funds for the purchase and rehab of foreclosed properties so that property values, particularly those in certain areas afflicted by foreclosure don't decline even more precipitously than they have already

Beyond the immediate response demanded for the housing crisis, it is now also crystal clear that we must rethink the regulatory framework that governs our financial system. Over the past decade, consolidation has become the norm in the financial industry. There are no longer distinct commercial banks, investment banks, broker-dealers, traders, insurers. Instead, there are a large number of financial institutions offering a constellation of financial products surrounded by many smaller institutions—such as hedge funds and private equity funds—with their own specialties. It's as though we have a handful of large financial Jupiters that are becoming more and more similar encircled by numerous small asteroids.

The U.S. financial regulatory system is still based on the crisis we responded to in the 20's and 30's, not on the 21st century financial institutions we have now. We want entrepreneurial vigor in our system and over-regulation can stifle that; but we also need robust regulation, particularly to guard against systemic risks.

I said this week that Secretary Paulson's blueprint is a good foundation for updating the regulation of U.S. markets. But, it leaves much to be desired and most importantly doesn't address the housing and economic crisis we face right now. If we focus only on consolidation of regulatory bodies—and also don't adopt a careful, but more pro-regulation, approach—then we will have approached this modernizing task with a pre-Bear Stearns mindset. I believe that there are six principles that we should follow as we re-regulate:

First, we must focus on controlling systemic risk.

Second, we need to look closely at unifying and simplifying our regulatory structure, perhaps moving toward a single regulator.

Third, we must figure out how to regulate the currently unregulated parts of financial markets, especially opaque and complex financial instruments that now put the entire system at risk.

Fourth, we must recognize that a global financial world requires global solutions. Fifth, we must have greater transparency.

And sixth, the laissez-faire view that predominates in this administration, far greater than it did under Ronald Reagan or George Bush Sr.'s has to change. Regulators ought to regulate.

I hope that you'll use your position to jawbone this administration to get behind the housing relief effort before Congress this week. They have not committed to it. *Addressing the housing crisis head-on will do as much to instill confidence in the markets as lowering interest rates or bolstering regulatory oversight of wayward mortgage lenders and financial institutions. We need to do all of it. Thank you Mr. Chairman.*

PREPARED STATEMENT SENATOR SAM BROWNBACK

Thank you, Mr. Chairman. I appreciate you scheduling this hearing and appreciate a very busy Federal Reserve Board Chairman taking time to share his views on the state of our economy and our financial markets. I am certain that when you scheduled this hearing back in February, you were unaware of how dramatic the preceding 3 weeks were going to be for our financial markets.

While I have some questions and philosophical concerns over the actions taken by the Federal Reserve in conjunction with Bear Stearns, based upon what I know, it appears that the Federal Reserve's swift and decisive actions were both appropriate and necessary. Chairman Bernanke, thank you for your strong and decisive leadership. I do not believe there is a single member of this committee that does not recognize that liquid and properly functioning financial markets are critical to the Nation's economic future.

Following the news of events unfolding at Bear Stearns, your response at the Federal Reserve, the markets' response to those actions, and Treasury's proposal to revamp the financial sector's regulatory structure provided a stark reminder of how important confidence in markets is to their efficient operation. And recent events provided a warning as to how fragile markets become when confidence evaporates.

There has been a great deal of finger pointing as to who is to blame for the current situation: unscrupulous mortgage brokers, dishonest borrowers, incompetent actions by rating agencies, irresponsible speculators, greedy investment bankers and commercial bankers. Putting aside the finger pointing for a moment, it appears to me that the failure to quantify accurately the true risk of highly leveraged transactions lies at the epicenter of the current situation.

Unfortunately, there does not appear to be a learning curve associated with financial crises, because we seem to repeat them every decade or so. We can look to the popping of the dot coM bubble in the late 1990s, the stock market plunge in October 1987, the S&L crisis in the 1980s, Continental Illinois before that, and on and on. In each case, in the euphoria of good times, we appear to not adequately acknowledge that what seem to be improbable outcomes can actually arise. And we seem not to adequately protect against the risk' of those improbable events coming to fruition and resulting in very large losses.

I do not think that you can always spot speculative excesses that lead to asset price bubbles. But when we observe things like escalator clauses in real estate contracts and no documentation mortgage lending, we should start to get concerned. And I fear that the regulators, in the euphoria of good times, simply fell asleep at the wheel. We described real estate markets as being characterized by pockets of "froth." But what turned out to be gambles on real estate prices ended up influencing the financial stability of our Nation's financial system.

We find that the Fed accommodated financing for the acquisition of Bear Stearns because that company effectively faced a crisis of confidence and their claimants staged a run on the institution. Evidently, the Fed deemed Bear Stearns as too big to send to bankruptcy, for fear of threats to the systemic stability of the Nation's financial system. If the Federal Reserve is going to take private-sector assets onto its balance sheet, I would hope that we at least have the Fed and others monitoring what the people who bought those assets were doing.

If private institutions engage in highly leveraged bets, and those bets turn out to go sour, we are putting U.S. taxpayer funds at risk when the Fed ends up effectively guaranteeing some or all of the value of those bets. If that is what we are going to do, then don't we at least need oversight into what bets are allowable? With the advent of hedge funds, off balance sheet financial entities, sovereign wealth funds and the like, who's bets are we willing to back? These are important public policy questions that need definitive answers if the world is to have faith that promises made in U.S. financial markets will be honored without imposing undue risk from rogue speculators.

While you have a lot of smart people working at the Federal Reserve, I am concerned when the taxpayer's money becomes the "skin in the game" to rescue supposedly sophisticated investment and commercial banks from the results of their own poor decisionmaking. I am extremely interested in learning more about what

processes the Federal Reserve will utilize to quantify the financial risk to the taxpayer resulting from the Fed's $29 billion backstop to the Bear Stearns-JP Morgan marriage.

As the Federal Reserve continues to study the meltdown in the subprime mortgage market, I hope that you will undertake an evaluation of the degree to which the failure to implement quality control standards on mortgage originating activity contributed to the current crisis.

I know that there are individuals at the Federal Reserve and in other regulatory agencies that will likely argue that the current system of rules, examinations, and audits are more than adequate. Current circumstances suggest that they were not.

Specifically, I would like the Federal Reserve to determine if instituting a system of rating originators for the completeness and accuracy of the data they provide lenders and making that part of a loan's rating would, based on an evaluation of real world data, have prevented some of these loans from being made or from being securitized.

From my perspective, this would add exactly the kind of transparency and more granular information called for in the President's Working Group report. The essence of meaningful quality control and risk management is to constantly test those systems for material weaknesses.

As you know, the Senate is considering housing legislation this week. One of the issues under consideration is whether or not to amend the bankruptcy code to allow bankruptcy courts to amend the terms of mortgages on principal residences. I am interested to know if you believe such a change would add additional uncertainty to the market for mortgage-backed securities in a way that would impair the ability of those markets to recover from their current state and provide reasonable risk-based financing to deserving low credit borrowers.

On another note, I would like to express for the record my continuing concern over the Senate's failure to give you a full complement of Federal Reserve Governors and the President a full Council of Economic Advisers at this critical juncture for our economy.

Again, Mr. Chairman, thank you for scheduling today's hearing. Chairman Bernanke, thank you for being here and for your continuing vigilance. I look forward to your testimony and the exchange during the question and answer period.

JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER, CHAIRMAN
REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

Good morning. I would like to thank Chairman Schumer for holding this hearing to examine the economic outlook. I want to welcome Chairman Bernanke and thank him for testifying here today.

Yesterday, Speaker Pelosi called on the President to join in a bipartisan economic summit to focus on the kitchen table concerns of American families. At this moment in history, we need to come together to solve our nation's serious economic challenges.

The Bush Administration's blueprint for regulatory reform is a distraction from the problems at hand. Even if the plan were put in place today, it would make no difference in the current crisis.

Our regulatory system is in serious need of renovation because financial innovation has surpassed our ability to protect consumers and hold institutions accountable. But we should not rush to revamp our regulatory system until we are sure we understand the problems. As former Treasury Secretary Lawrence Summers recently observed, "It's probably a bad idea to spend too much time debating the organization of the fire department while the fire is still burning and no independent investigation of the cause of the fire has yet been completed."

We should instead move quickly to keep families in their homes and blunt the devastating effects of the weakening economy. The decline in home prices is causing banks to readjust their balance sheets and to buildup capital, which is at the core of the liquidity crisis. Economists warn that containing financial volatility will be difficult until housing prices stop falling, which is why Congress is working on solutions to keep people in their homes and avoid a deep downturn.

Rep. Barney Frank and Sen. Chris Dodd have proposed a $300 billion loan guarantee program through the Federal Housing Administration, which would allow the nearly nine million homeowners with negative-equity to refinance their mortgages at reasonable rates. And for homes already in foreclosure, another measure would make $10 billion available in grants and loans to states to buy foreclosed properties and allow families to either buy or rent them.

The crisis in the housing market has brought to light the inability of our most sophisticated and respected institutions to measure their exposure to opaque assets, and more importantly to manage the risks associated with them. To underscore this challenge, my respected constituent former Treasury Secretary Robert Rubin recently said that he hadn't even heard of "liquidity puts"—an obscure kind of financial contract—until they started causing big problems for Citigroup. I hope we will hear from you, Chairman Bernanke, about what we should do to increase transparency for complex investment products to assure smoothly functioning markets. In recent weeks we've heard calls for the Fed to oversee risk across the broad financial spectrum and I know we are all anxious to hear your thoughts on this.

In order to forestall a meltdown of the financial sector, the Fed has recently employed some creative, unprecedented and controversial steps to ease the credit crunch which have come to resemble the spontaneous improvisation of jazz. I hope that Chairman Bernanke's respected academic research prior to joining the Fed will help us to avoid repeating the mistakes of the Great Depression. Clearly, we are in uncharted territory.

The Federal Reserve has recently come under fire for making a $29 billion line of credit available to JP Morgan Chase to acquire investment giant Bear Stearns. This action to head off a sudden collapse of one of the nation's largest investment banks, however, very likely prevented widespread financial panic and a potential domino effect among other financial institutions.

Wall Street has been helped. Now it is time to help Main Street.

We should take this moment in history to build on the stimulus plan by considering additional measures to strengthen the economy. It is most likely too late to avoid the second economic downturn of President Bush's Administration, but it is not too late for the Administration to work with Congress to prevent families from losing their homes, put people back to work, and restore confidence in our economy.

Mr. Chairman, thank you for holding this hearing and I look forward to gaining some insights into conditions in the financial market and the economic outlook.

PREPARED STATEMENT REPRESENTATIVE KEVIN BRADY

I am pleased to join in welcoming Chairman Bernanke before the Joint Economic Committee this morning. Chairman Bernanke's testimony comes at a critical time given the financial turmoil that has challenged Federal Reserve policymakers in recent months.

The U.S. economy, which had grown at a 4.9 percent rate in the third quarter of last year, has slowed dramatically. Home building has fallen sharply as housing prices have continued to decline, undermining the value of mortgage-backed securities. Since last summer it has been clear that the riskiness of many of these investments was greatly underestimated by both investors and regulators.

A reappraisal of risk in the financial markets has led to the realization that many mortgage-related investments as well as other securities are of dubious quality. Major banks and other financial institutions have had to make large write-downs of assets that have, in turn, eroded their capital and limited their ability to lend to households and firms in the future. Segments of the financial markets have seized up, requiring aggressive Federal Reserve actions to limit instability.

The Fed has responded by slashing short-term interest rates and developing new and innovative ways of providing liquidity to the financial system. By extending its lending facilities to primary dealers and expanding the scope of acceptable collateral, the Fed has helped to contain at least some of the recent financial market instability.

The events of recent weeks have made it very clear that a major reform of financial regulation is needed, as noted by Secretary Paulson. The current structure of financial regulation dates back to the 1930s and does not reflect the financial innovation that has occurred in recent decades. Some streamlining and consolidation obviously is needed whether or not one agrees entirely with every detail in the new Treasury proposal for financial regulatory reform.

At this time of financial instability and uncertainty, the Federal Reserve has taken important steps to respond in a way that improves the prospects for economic growth. Congress has also made a contribution by enacting the economic stimulus legislation. The monetary and fiscal policy actions taken to date improve the outlook for the second half of the year, but more remains to be done. Given the circumstances, Congress must also reject steps to increase taxes or take other actions that would undermine future economic growth.

PREPARED STATEMENT OF REPRESENTATIVE RON PAUL

Mr. Chairman,

I have never been opposed to regulation, although my idea of regulation differs from that of many people in Washington. The free market and its forces of supply and demand are the most effective regulator of the private sector, and have never been known to fail absent government intervention. But piling more public sector regulation on the private sector will have a detrimental effect on the health of our financial system and sow the seeds for the next financial meltdown.

What we in Washington should be discussing is increased regulation and scrutiny of public sector regulatory and oversight agencies such as the Federal Reserve Board, the SEC, and others. The Federal Reserve's actions got us into at least one depression in the last century, and have led to continued cyclical difficulties, including the current economic slowdown.

Back in the 1970s, government-caused inflation reached levels high enough that the Nixon administration decided to implement wage and price controls. Placing blame on greedy speculators, unscrupulous mortgage originators, or panicky investors, is a common reaction on the part of government.

The solution called for, despite the numerous documented failures of government regulation, is always more regulation, more government involvement in and control over the economy, and less free enterprise. Never is the blame placed squarely where it belongs, which is on the shoulders of legislators and regulators whose actions distort the market, prohibiting legitimate market activities and encouraging the development of labyrinthine and opaque financial schemes.

The latest regulatory plan from the Treasury Department, with the potential to turn the Federal Reserve into a super-regulator overseeing state-chartered banks, bank holding companies, and acting as a guarantor of market stability, is another in a long line of half-baked government responses to financial difficulty. Recession

after recession has not impressed upon government leaders the reality that the Federal Reserve's monetary policy activities are what lead to market instability.

The business cycle, contrary to what Secretary Paulson and others seem to believe, is not endemic to the free market. It is always and everywhere the result of monetary inflation and subsequent malinvestment, which when it is discovered must of necessity be liquidated in order for a true recovery to occur. Delaying the liquidation will only prolong the crisis and ensure that the next crisis will be more severe.

Every government intervention will result in a distortion of the market and a subsequent shock somewhere down the line in the future. It is about time that we recognize the failure of government intervention, get our hands out of the private sector, and for once allow the market to function.

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

Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of the Committee, I am pleased to appear before the Joint Economic Committee. In response to deterioration in the near-term outlook for the economy and intensified strains in financial markets, in recent months the Federal Reserve has eased monetary policy substantially further and taken strong actions to increase market liquidity. In my remarks today, I will first offer my views on conditions in financial markets and the outlook for the U.S. economy, then discuss recent actions taken by the Federal Reserve.

Although our recent actions appear to have helped stabilize the situation somewhat, financial markets remain under considerable stress. Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and have increased the amount of collateral they require to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices.

Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises (GSEs), have reported substantial losses and writedowns, reducing their available capital. Several of these firms have been able to raise fresh capital to offset at least some of those losses, and others are in the process of doing so. However, financial institutions' balance sheets have also expanded, as banks and other institutions have taken on their balance sheets various assets that can no longer be financed on a standalone basis. Thus, the capacity and willingness of some large institutions to extend new credit remains limited.

The effects of the financial strains on credit cost and availability have become increasingly evident, with some portions of the system that had previously escaped the worst of the turmoil—such as the markets for municipal bonds and student loans—having been affected. Another market that had previously been largely exempt from disruptions was that for mortgage-backed securities (MBS) issued by government agencies. However, beginning in mid-February, worsening liquidity conditions and reports of losses at the GSEs, Fannie Mae and Freddie Mac, caused the spread of agency MBS yields over the yields on comparable Treasury securities to rise sharply. Together with the increased fees imposed by the GSEs, the rise in this spread resulted in higher interest rates on conforming mortgages. More recently, agency MBS spreads and conforming mortgage rates have retraced part of this increase, and conforming mortgages continue to be readily available to households. However, for the most part, the nonconforming segment of the mortgage market continues to function poorly.

In corporate debt markets, yields and spreads on both investment-grade and speculative-grade corporate bonds rose through mid-March before falling more recently. Issuance of investment-grade bonds by both financial and nonfinancial corporations has been quite robust so far this year, but issuance of new high-yield debt has stalled. Strains continue to be evident in the commercial paper market as well, where risk spreads remain elevated and the quantity of commercial paper outstanding, particularly asset-backed paper, has decreased. Commercial and industrial loans at banks grew in January and February, but at a considerably slower pace than in previous months.

These developments in financial markets—which themselves reflect, in part, greater concerns about housing and the economic outlook more generally—have weighed on real economic activity. Notably, in the housing market, sales of both new

and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall[1] Starts of new single-family homes declined an additional 7 percent in February, bringing the cumulative decline since the early 2006 peak in single-family starts to more than 60 percent. Residential construction is likely to contract somewhat further in coming quarters as builders try to reduce their high inventories of unsold new homes.

Private payroll employment fell 101,000 in February, after 2 months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline. But the demand for labor has also moderated recently in other industries, such as business services and retail trade, and manufacturing employment has continued on its downward trend. Meanwhile, claims for unemployment insurance have risen somewhat on balance, and surveys indicate that employers have scaled back hiring plans and that jobseekers are experiencing greater difficulties finding work. The unemployment rate edged down in February and remains at a relatively low level; however, in light of the sluggishness of economic activity and other indicators of a softer labor market, I expect it to move somewhat higher in coming months.

After rising at an annual rate of about 3 percent over the first three quarters of last year, real disposable income has since increased at only about a 1 percent annual rate, reflecting weaker employment conditions and higher prices for energy and food. Concerns about employment and income prospects, together with declining home values and tighter credit conditions, have caused consumer spending to decelerate considerably from the solid pace seen during the first three quarters of last year. I expect the tax rebates associated with the fiscal stimulus package recently passed by the Congress to provide some support to consumer spending in coming quarters.

In the business sector, the pullback in hiring that I noted earlier has been accompanied by some reduction in capital spending plans, as weaker sales prospects, tighter credit, and heightened uncertainty have made business leaders more cautious. On a more positive note, the nonfinancial business sector remains financially sound, with liquid balance sheets and low leverage ratios, and most firms have been able to avoid unwanted buildups in inventories. In addition, many businesses are enjoying strong demand from abroad. Although the prospects for foreign economic growth have diminished somewhat in recent months, net exports should continue to provide considerable support to U.S. economic activity in coming quarters.

Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee (FOMC) at the end of January. It now appears likely that real gross domestic product (GDP) will not grow much, if at all, over the first half of 2008 and could even contract slightly. We expect economic activity to strengthen in the second half of the year, in part as the result of stimulative monetary and fiscal policies; and growth is expected to proceed at or a little above its sustainable pace in 2009, bolstered by a stabilization of housing activity, albeit at low levels, and gradually improving financial conditions. However, in light of the recent turbulence in financial markets, the uncertainty attending this forecast is quite high and the risks remain to the downside.

Inflation has also been a source of concern. The price index for personal consumption expenditures rose 3.4 percent over the twelve months ending in February, up from 2.3 percent over the preceding twelve-month period. To a large extent, this pickup in inflation has been the result of sharp increases in the prices of crude oil, agricultural products, and other globally traded commodities. Additionally, the decline in the foreign exchange value of the dollar has boosted some non-commodity import prices and thus contributed to inflation. However, the so-called core rate of inflation—that is, inflation excluding food and energy prices—has edged down recently after firming somewhat late last year.

We expect inflation to moderate in coming quarters. That expectation is based, in part, on futures markets' indications of a leveling out of prices for oil and other commodities, and it is consistent with our projection that global growth—and thus the demand for commodities—will slow somewhat during this period. And, as I noted, we project an easing of pressures on resource utilization. However, some indicators of inflation expectations have risen, and, overall, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully in the months ahead.

I turn now to the Federal Reserve's policy responses to these financial and economic developments.

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[1] In February, sales of existing homes are reported to have turned up slightly, but sales of new homes continued to move down.

Well-functioning financial markets are essential for the efficacy of monetary policy and, indeed, for economic growth and stability. To improve market liquidity and market functioning, and consistent with its role as the nation's central bank, the Federal Reserve has supplemented its longstanding discount window by establishing three new facilities for lending to depository institutions and primary dealers.

The lending facilities now in place offer depository institutions and primary dealers two complementary alternatives for meeting funding needs. One pair of facilities—the discount window for depository institutions and the Primary Dealer Credit Facility for primary dealers—offers daily access to variable amounts of funding at the initiative of the borrowing institution. A second pair of facilities—the Term Auction Facility for depository institutions and the Term Securities Lending Facility for primary dealers—makes available predetermined aggregate amounts of longer-term funding on pre-announced dates, with the interest rate and the distribution of the awards across institutions being determined by competitive auction. Although these facilities operate through depository institutions and primary dealers, they are designed to support the broad financial markets and the economy by facilitating the provision of liquidity by those institutions to their customers and counterparties.

The Primary Dealer Credit Facility was put in place in the wake of the near-failure of Bear Stearns, a large investment bank. On March 13, Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for Chapter 11 bankruptcy the next day unless alternative sources of funds became available. This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Steams participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences of such a failure for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The Federal Reserve has taken additional measures to improve market liquidity. We have initiated a series of twenty-eight-day single-tranche term repurchase transactions with primary dealers, expected to cumulate to $100 billion outstanding, in which dealers may offer any of the types of collateral that are eligible for conventional open market operations. We have also expanded and extended reciprocal currency arrangements ("swap lines") with the European Central Bank and the Swiss National Bank. Using these swap lines, the participating central banks are providing dollar liquidity to financial institutions in their jurisdictions, which should improve the functioning of the global market for dollar funding. These facilities and programs will be kept in place as long as conditions warrant their ongoing use. We are working closely with the Securities Exchange Commission to monitor the financial conditions and funding positions of primary dealers who might seek Federal Reserve credit.

To date, the recent liquidity measures implemented by the Federal Reserve seem to have been helpful in addressing some of the strains in financial markets. Funding pressures on primary dealers appear to have eased somewhat, and liquidity seems to have improved in several markets, including—as noted earlier—the market for agency mortgage-backed securities. To the extent that these measures improve market functioning, they will have favorable effects on the ability and willingness to make credit available to the broader economy. More-liquid markets also increase the efficacy of monetary policy, which in turn improves our ability to meet the goals set for us by the Congress—namely, to promote maximum employment and price stability.

As you know, in response to the further weakening of economic conditions, the Federal Reserve has continued to ease the stance of monetary policy. The FOMC reduced its target for the Federal funds rate by a total of 125 basis points in January and by an additional 75 basis points at its March meeting, leaving the current

target at 2¼ percent—3 percentage points below its level last summer. As the Committee noted in its most recent post-meeting statement, we anticipate that these actions, together with the steps we have taken to foster market liquidity, will help to promote growth over time and to mitigate the risks to economic activity.

Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. I remain confident in our economy's long-term prospects.

Thank you. I would be pleased to take your questions.

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