Ben S Bernanke: Frequently asked questions

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the Economic Club of Washington DC, Washington DC, 7 December 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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It is a pleasure to speak once again before the Economic Club of Washington. Having faced the most serious financial crisis and the worst recession since the Great Depression, our economy has made important progress during the past year. Although the economic stress faced by many families and businesses remains intense, with job openings scarce and credit still hard to come by, the financial system and the economy have moved back from the brink of collapse, economic growth has returned, and the signs of recovery have become more widespread.

Understandably, in a situation as complicated as this one, people have many questions about the current situation and the path forward. Accordingly, taking inspiration from the ubiquitous frequently-asked-questions lists, or FAQs, on Internet websites, in my remarks today I'd like to address four important FAQs about the economy and the Federal Reserve. They are:

1. Where is the economy headed?
2. What has the Federal Reserve been doing to support the economy and the financial system?
3. Will the Federal Reserve's actions lead to higher inflation down the road?
4. How can we avoid a similar crisis in the future?

Where is the economy headed?

First, to understand where the economy might be headed, we should take a look at where it has been recently.[1] A year ago, our economy – indeed, all of the world's major economies – were reeling from the effects of a devastating financial crisis. Policymakers here and abroad had undertaken an extraordinary series of actions aimed at stabilizing the financial system and cushioning the economic impact of the crisis. Critically, these policy interventions succeeded in averting a global financial meltdown that could have plunged the world into a second Great Depression. But although a global economic cataclysm was avoided, the crisis nevertheless had widespread and severe economic consequences, including deep recessions in most of the world's major economies. In the United States, the unemployment rate, which was as low as 4.4 percent in March 2007, currently stands at 10 percent.

Recently we have seen some pickup in economic activity, reflecting, in part, the waning of some forces that had been restraining the economy during the preceding several quarters. The collapse of final demand that accelerated in the latter part of 2008 left many firms with excessive inventories of unsold goods, which in turn led them to cut production and employment aggressively. This phenomenon was especially evident in the motor vehicle industry, where automakers, a number of whom were facing severe financial pressures, temporarily suspended production at many plants. By the middle of this year, however,

[1] For more discussion, see Ben S. Bernanke (2009), "*On the Outlook for the Economy and Policy*", speech delivered at the Economic Club of New York, New York, N.Y., November 16.

inventories had been sufficiently reduced to encourage firms in a wide range of industries to begin increasing output again, contributing to the recent upturn in the nation's gross domestic product (GDP).[2]

Although the working down of inventories has encouraged production, a sustainable recovery requires renewed growth in final sales. It is encouraging that we have begun to see some evidence of stronger demand for homes and consumer goods and services. In the housing sector, sales of new and existing homes have moved up appreciably over the course of this year, and prices have firmed a bit. Meanwhile, the inventory of unsold new homes has been shrinking. Reflecting these developments, homebuilders have somewhat increased the rate of new construction – a marked change from the steep declines that have characterized the past few years.

Consumer spending also has been rising since midyear. Part of this increase reflected a temporary surge in auto purchases that resulted from the "cash for clunkers" program, but spending in categories other than motor vehicles has increased as well. In the business sector, outlays for new equipment and software are showing tentative signs of stabilizing, and improving economic conditions abroad have buoyed the demand for U.S. exports.

Though we have begun to see some improvement in economic activity, we still have some way to go before we can be assured that the recovery will be self-sustaining. Also at issue is whether the recovery will be strong enough to create the large number of jobs that will be needed to materially bring down the unemployment rate. Economic forecasts are subject to great uncertainty, but my best guess at this point is that we will continue to see modest economic growth next year – sufficient to bring down the unemployment rate, but at a pace slower than we would like.

A number of factors support the view that the recovery will continue next year. Importantly, financial conditions continue to improve: Corporations are having relatively little difficulty raising funds in the bond and stock markets, stock prices and other asset values have recovered significantly from their lows, and a variety of indicators suggest that fears of systemic collapse have receded substantially. Monetary and fiscal policies are supportive. And I have already mentioned what appear to be improving conditions in housing, consumer expenditure, business investment, and global economic activity.

On the other hand, the economy confronts some formidable headwinds that seem likely to keep the pace of expansion moderate. Despite the general improvement in financial conditions, credit remains tight for many borrowers, particularly bank-dependent borrowers such as households and small businesses. And the job market, though no longer contracting at the pace we saw in 2008 and earlier this year, remains weak. Household spending is unlikely to grow rapidly when people remain worried about job security and have limited access to credit.

Inflation is affected by a number of crosscurrents. High rates of resource slack are contributing to a slowing in underlying wage and price trends, and longer-run inflation expectations are stable. Commodities prices have risen lately, likely reflecting the pickup in global economic activity and the depreciation of the dollar. Although we will continue to monitor inflation closely, on net it appears likely to remain subdued for some time.

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2 The three-month diffusion index for manufacturing – a measure of the breadth of production changes across industry categories – stood at 63.8 percent in September. See Board of Governors of the Federal Reserve System (2009), Statistical Release G.17, "*Industrial Production and Capacity Utilization*", Table 6: Diffusion Indexes of Industrial Production (November 17).

What has the Federal Reserve been doing to support the economy and the financial system?

The discussion of where the economy is headed brings us to our second question: What has the Federal Reserve been doing to support the economy and the financial system?

The Federal Reserve has been, and still is, doing a great deal to foster financial stability and to spur recovery in jobs and economic activity.[3] Notably, we began the process of easing monetary policy in September 2007, shortly after the crisis began. By mid-December 2008, our target rate was effectively as low as it could go – within a range of 0 to 1/4 percent, compared with 5-1/4 percent before the crisis – and we have maintained that very low rate for the past year.

Our efforts to support the economy have gone well beyond conventional monetary policy, however. I have already alluded to the Federal Reserve's close cooperation with the Treasury, the Federal Deposit Insurance Corporation (FDIC), and other domestic and foreign authorities in a concerted and ultimately successful effort to stabilize the global banking system, which verged on collapse following the extraordinary events of September and October 2008. We subsequently took strong measures, independently or in conjunction with other agencies, to help normalize key financial institutions and credit markets disrupted by the crisis. Among these were the money market mutual fund industry, in which large numbers of American households, businesses, and municipalities make short-term investments; and the commercial paper market, which many firms tap to finance their day-to-day operations. We also established and subsequently expanded special arrangements with other central banks to provide dollars to global funding markets, as we found that disruptions in dollar-based markets abroad were spilling over to our own markets.

More recently, we have played an important part in helping to re-start the markets for asset-backed securities that finance auto loans, credit card loans, small business loans, student loans, loans to finance commercial real estate, and other types of credit. By working to revive these markets, which allow banks to tap the broader securities markets to finance their lending, we have helped banks make room on their balance sheets for new credit to households and businesses. In addition, we have supported the overall functioning of private credit markets and helped to lower interest rates on bonds, mortgages, and other loans by purchasing unprecedented volumes of mortgage-related securities and Treasury debt.

In all of these efforts, our objective has not been to support specific financial institutions or markets for their own sake. Rather, recognizing that a healthy economy requires well-functioning financial markets, we have moved always with the single aim of promoting economic recovery and economic opportunity. In that respect, our means and goals have been fully consistent with the traditional functions of a central bank and with the mandate given to the Federal Reserve by the Congress to promote price stability and maximum employment.

In addition to easing monetary policy and acting to stabilize financial markets, we have worked in our role as a bank supervisor to encourage bank lending. In November 2008 we joined with other banking regulators to urge banks to continue lending to creditworthy borrowers – to the benefit of both the economy and the banks – and we have recently provided guidelines to banks for working constructively with troubled commercial real estate loans.[4] This spring, we led a coordinated, comprehensive examination of 19 of the country's

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[3] See Ben S. Bernanke (2009), "*Reflections on a Year of Crisis*", speech delivered at "*Financial Stability and Macroeconomic Policy*", a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 20–22.

[4] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "*Interagency Statement on Meeting the Needs of Creditworthy Borrowers*", joint press release, November 12, ; and Board of Governors of the Federal

largest banks, an exercise formally known as the Supervisory Capital Assessment Program, or SCAP, but more informally as the "stress test". This assessment was designed to ensure that these banks, which collectively hold about two-thirds of the assets of the banking system, would remain well capitalized and able to lend to creditworthy borrowers even if economic conditions turned out to be even worse than expected. The release of the assessment results in May provided sorely needed clarity about the banks' condition and marked a turning point in the restoration of confidence in our banking system.[5] In the months since then, and with the strong encouragement of the federal banking supervisors, many of these largest institutions have raised billions of dollars in new capital, improving their ability to withstand possible future losses and to extend loans as demand for credit recovers. Meanwhile, we have also continued our efforts to ensure fair treatment for the customers of financial firms. During the past year and a half, we have comprehensively overhauled the regulations protecting mortgage borrowers, credit card holders, and users of overdraft protection plans, among others.

In navigating through the crisis, the Federal Reserve has been greatly aided by the regional structure established by the Congress when it created the Federal Reserve in 1913. The more than 270 business people, bankers, nonprofit executives, academics, and community, agricultural, and labor leaders who serve on the boards of the 12 Reserve Banks and their 24 Branches provide valuable insights into current economic and financial conditions that statistics alone cannot. Thus, the structure of the Federal Reserve ensures that our policymaking is informed not just by a Washington perspective, or a Wall Street perspective, but also a Main Street perspective. Indeed, our Reserve Banks and Branches have deep roots in the nation's communities and do much good work there. They have, to give just a couple of examples, assisted organizations specializing in foreclosure mitigation and worked with nonprofit groups to help stabilize neighborhoods hit by high rates of foreclosure. They (as well as the Board) are also much involved in financial and economic education, helping people to make better financial decisions and to better understand how the economy works.

All told, the Federal Reserve's actions – in combination with those of other policymakers here and abroad – have helped restore financial stability and pull the economy back from the brink. Because of our programs, auto buyers have obtained loans they would not have otherwise obtained, college students are financing their educations through credit they otherwise likely would not have received, and home buyers have secured mortgages on more affordable and sustainable terms than they would have otherwise. These improvements in credit conditions in turn are supporting a broader economic recovery.

Will the Federal Reserve's actions lead to higher inflation down the road?

The scope and scale of our actions, however, while necessary and helpful in my view, have left some uneasy. In all, our asset purchases and lending have caused the Federal Reserve's balance sheet to more than double, from less than $900 billion before the crisis began to about $2.2 trillion today. Unprecedented balance sheet expansion and near-zero overnight interest rates raise our third frequently asked question: Will the Federal Reserve's actions to combat the crisis lead to higher inflation down the road?

The answer is no; the Federal Reserve is committed to keeping inflation low and will be able to do so. In the near term, elevated unemployment and stable inflation expectations should

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Reserve System (2009), "*Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts*", press release, October 30.

5 See Board of Governors of the Federal Reserve System (2009), "*Federal Reserve, OCC, and FDIC Release Results of the Supervisory Capital Assessment Program*", press release, May 7; and Board of Governors of the Federal Reserve System (2009), "*Federal Reserve Board Makes Announcement Regarding the Supervisory Capital Assessment Program (SCAP)*", press release, November 9.

keep inflation subdued, and indeed, inflation could move lower from here. However, as the recovery strengthens, the time will come when it is appropriate to begin withdrawing the unprecedented monetary stimulus that is helping to support economic activity. For that reason, we have been giving careful thought to our exit strategy. We are confident that we have all the tools necessary to withdraw monetary stimulus in a timely and effective way.[6]

Indeed, our balance sheet is already beginning to adjust, because improving financial conditions are leading to substantially reduced use of our lending facilities. The balance sheet will also shrink over time as the mortgage-backed securities and other assets we hold mature or are prepaid. However, even if our balance sheet stays large for a while, we will be able to raise our target short-term interest rate – which is the rate at which banks lend to each other overnight – and thus tighten financial conditions appropriately.

Operationally, an important tool for adjusting the stance of monetary policy will be the authority, granted to us by the Congress last year, to pay banks interest on balances they hold at the Federal Reserve. When the time comes to raise short-term interest rates and thereby tighten policy, we can do so by raising the rate that we offer banks on their balances with us. Banks will be unwilling to make overnight loans to each other at a rate lower than the rate that they can earn risk-free from the Fed, and so the interest rate we pay on banks' balances will tend to set a floor below our target overnight loan rate and other short-term interest rates.

Additional upward pressure on short-term interest rates can be achieved by measures to reduce the supply of funds that banks have available to lend to each other. We have a number of tools to accomplish this. For example, through the use of a short-term funding method known as reverse repurchase agreements, we can act directly to reduce the quantity of reserves held by the banking system. By paying a slightly higher rate of interest, we could induce banks to lock up their balances in longer-term accounts with us, making those balances unavailable for lending in the overnight market. And, if necessary, we always have the option of reducing the size of our balance sheet by selling some of our securities holdings on the open market.

As always, the most difficult challenge for the Federal Open Market Committee will not be devising the technical means of unwinding monetary stimulus. Rather, it will be the challenge that faces central banks in every economic recovery, which is correctly judging the best time to tighten policy. Because monetary policy affects the economy with a lag, we will need to base our decision on our best forecast of how the economy will develop. As I said a few moments ago, we currently expect inflation to remain subdued for some time. It is also reassuring that longer-term inflation expectations appear stable. Nevertheless, we will keep a close eye on inflation risks and will do whatever is necessary to meet our mandate to foster both price stability and maximum employment.

How can we avoid a similar crisis in the future?

As we at the Federal Reserve and others work to build on the progress already made toward securing a sustained economic recovery with price stability, we must also continue to address the weaknesses that led to the current crisis. Thus, our final question this afternoon is: How can we avoid a similar crisis in the future?[7]

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6 See Ben S. Bernanke (2009), "*The Federal Reserve's Balance Sheet: An Update*", speech delivered at the Federal Reserve Board Conference on Key Developments in Monetary Policy, Washington, October 8; and Ben S. Bernanke (2009), "*The Fed's Exit Strategy*", Opinion, *Wall Street Journal*, July 21.

7 See Ben S. Bernanke (2009), "*Financial Regulation and Supervision after the Crisis: The Role of the Federal Reserve*", speech delivered at the Federal Reserve Bank of Boston 54th Economic Conference, held in Chatham, Mass., October 23.

Although the sources of the crisis were extraordinarily complex and numerous, a fundamental cause was that many financial firms simply did not appreciate the risks they were taking. Their risk-management systems were inadequate and their capital and liquidity buffers insufficient. Unfortunately, neither the firms nor the regulators identified and remedied many of the weaknesses soon enough. Thus, all financial regulators, including the Federal Reserve, must undertake unsparing self-assessments. At the Federal Reserve, we have extensively reviewed our performance and moved to strengthen our oversight of banks. Working cooperatively with other agencies, we are toughening our banking regulations to help constrain excessive risk-taking and enhance the ability of banks to withstand financial stress. For example, we have been among the leaders of international efforts, through organizations such as the Basel Committee on Bank Supervision, to increase the quantities of capital and liquidity that banks must hold. At home, we are implementing standards that require banking organizations to adopt compensation policies that link pay to the institutions' long-term performance and avoid encouraging excessive risk-taking.

I mentioned the SCAP, otherwise known as the stress tests. We are applying the lessons learned in that exercise to reorient our approach to the supervision of large, interconnected banking organizations that are critical to the stability of the financial system. In particular, we are taking a more "macroprudential" approach, one that goes beyond supervisors' traditional focus on the health of individual institutions and scrutinizes the interrelationships among firms and markets to better anticipate sources of financial contagion. To do that, we are expanding our use of the kind of simultaneous and comparative cross-firm examinations that we used to such good effect in the SCAP. The Federal Reserve's ability to draw on a range of disciplines – using economists, market experts, accountants, and lawyers, in addition to bank examiners – was essential to the success of the SCAP, and a multidisciplinary approach will be a central feature of our supervision in the future. For example, we are complementing our traditional onsite examinations with enhanced off-site surveillance programs, under which multidisciplinary teams will combine supervisory information, firm-specific data analysis, and market-based indicators to identify problems that may affect one or more banking institutions.

Although regulators can do a great deal on their own to improve financial oversight, the Congress also must act to fix gaps and weaknesses in the structure of the regulatory system and, in so doing, address the very serious problem posed by firms perceived as "too big to fail". No firm, by virtue of its size and complexity, should be permitted to hold the financial system, the economy, or the American taxpayer hostage. To eliminate that possibility, a number of steps are required.

First, *all* systemically important financial institutions, not only banks, should be subject to strong and comprehensive supervision on a consolidated, or firmwide, basis. Such institutions should be subject to tougher capital, liquidity, and risk-management requirements than other firms – both to reduce their chance of failing and to remove their incentive to grow simply in order to be perceived as too big to fail. Neither AIG, an insurance company, nor Bear Stearns, an investment firm, was subject to strong consolidated supervision. The Federal Reserve, as the regulator of bank holding companies, already supervises many of the largest and most complex institutions in the world. That experience, together with our broad knowledge of the financial markets, makes us well suited to serve as the consolidated supervisor for systemically important nonbank institutions as well. In addition, our involvement in supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions of promoting financial stability and making monetary policy.

Second, when a systemically important institution does approach failure, government policymakers must have an option other than a bailout or a disorderly, confidence-shattering bankruptcy. The Congress should create a new resolution regime, analogous to the regime currently used by the FDIC for failing banks, that would permit the government to wind down a troubled systemically important firm in a way that protects financial stability but that also imposes losses on shareholders and creditors of the failed firm, without costs to the taxpayer. Imposing losses on creditors of troubled, systemically critical firms would help address the too-big-to-fail problem by restoring market discipline and leveling the playing field for smaller firms, while minimizing the disruptive effects of a failure on the financial system and the economy.

Third, our regulatory structure requires a better mechanism for monitoring and addressing emerging risks to the financial system as a whole. Because of the size, diversity, and complexity of our financial system, that task may exceed the capacity of any individual agency. The Federal Reserve therefore supports the creation of a systemic oversight council, made up of the principal financial regulators, to identify developments that may pose systemic risks, recommend approaches for dealing with them, and coordinate the responses of its member agencies.

Conclusion

In closing, I will again note that in the fall of last year, the United States, indeed the world, confronted a financial crisis of a magnitude unseen for generations. Concerted actions by the Federal Reserve and other policymakers here and abroad helped avoid the worst outcomes. Nevertheless, the turmoil dealt a severe blow to our economy from which we have only recently begun to recover. The improvement in financial conditions this year and the resumption of growth over the summer offer the hope and expectation of continued recovery in the new year. However, significant headwinds remain, including tight credit conditions and a weak job market.

The Federal Reserve has been aggressive in its efforts to stabilize our financial system and to support economic activity. At some point, however, we will need to unwind our accommodative policies in order to avoid higher inflation in the future. I am confident we have both the tools and the commitment to make that adjustment when it is needed and in a manner consistent with our mandate to foster employment and price stability.

In the meantime, financial firms must do a better job of managing the risks of their business, regulators – the Federal Reserve included – must complete a thoroughgoing overhaul of their approach to supervision, and the Congress should move forward in making needed changes to our system of financial regulation to avoid a similar crisis in the future. In particular, we must solve the problem of “too big to fail”.

In sum, we have come a long way from the darkest period of the crisis, but we have some distance yet to go. In the midst of some of the toughest days, in October 2008, I said in a speech that I was confident that the American economy, with its great intrinsic vitality, would emerge from that period with renewed vigor.[8] I remain equally confident today.

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[8] See Ben S. Bernanke (2008), “*Stabilizing the Financial Markets and the Economy*”, speech delivered at the Economic Club of New York, New York, N.Y., October 15.